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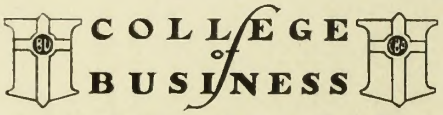

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BUSINESS INSURANCE TRUSTS

THEORY AND PRACTICE

BY

DOROTHEA BARTON COGSWELL

B.S. in B.A., Boston University, 1931

A Thesis

Submitted to

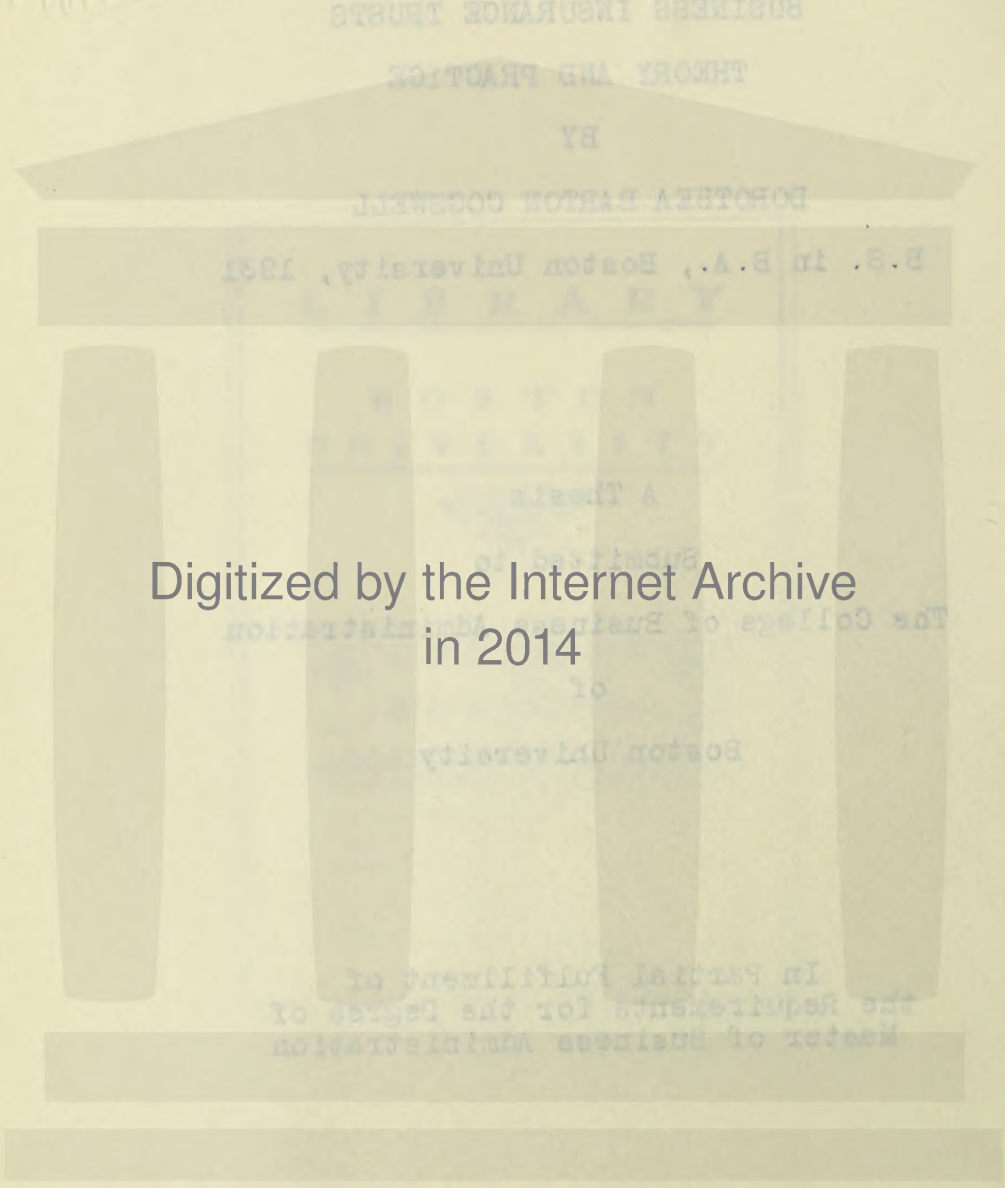
The College of Business Administration

of

Boston University

In Partial Fulfillment of
the Requirements for the Degree of
Master of Business Administration

1933



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LIST OF ABBREVIATIONS

Simon.....	Leon Gilbert Simon: "Business Insurance"
Perrin and Babb - Vol. II..	Perrin and Babb: "Commercial Law Cases" - Vol. II - 1928
"100 Questions and Answers".	"100 Questions and Answers on Business Insurance and Business Insurance Trusts"
I.T.B. #3.....	"Insurance Trust Bulletin #3"
Pro. 11th - 1930.....	"Proceedings - Eleventh Mid-Winter Trust Conference, New York, February, 1930"
Pro. 12th - 1931.....	"Proceedings - Twelfth Mid-Winter Trust Conference, New York, February, 1931"
Pro. 13th - 1932.....	"Proceedings - Thirteenth Mid-Winter Trust Conference, New York, February, 1932"
A.B.A. - "Guide to Trust Fees".....	"Guide to Trust Fees - With Recommended Cost Accounting System"
Manning Manse - 1929.....	"Proceedings of a Selected Group of Life Underwriters at Manning Manse, October 18, 1929"
Manning Manse - 1930.....	"A Verbatim Report of a Joint Meeting of Life Underwriters and Officers of the Trust Department of the Atlantic National Bank of Boston at the Manning Manse, November 12, 1930"
G.L. c. 155,156.....	General Laws of Massachusetts, c. 155, 156
T. Cos.....	"Trust Companies"
Boston Life Insurance Trust Council Notes.....	Cases discussed at meetings of the Boston Life Insurance Trust Council, 1932

BUSINESS INSURANCE TRUSTS

THEORY AND PRACTICE

PART I. THE THEORY OF BUSINESS INSURANCE TRUSTS

I. Definition of Business Insurance Trusts.--Business insurance - i.e. insurance which is written on the life or lives of one or more of the principals in a business and the proceeds of which are to be employed in some directed manner for the interests of that business - is designed to fill some distinct, individual need. "From its very inception it usually becomes an asset of a business or a means by which the value of a decedent's interest ..... will be secured to his beneficiaries while the interest itself passes to others."[1] And after the "business insurance" idea has found acceptance, "business insurance trusts" form the next logical step, because these trusts make the proceeds of the policies written on the life or lives of one or more of the principals in the organization payable to a bank or trust company as trustee, for collection and disbursement under the terms of a written agreement drawn up between the principals and the trustee. Thus a trust of this type is really a "buy and sell agreement" providing for the sale of the decedent's interest, with the addition of a disinterested third party to guide the makers of the

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II. Growth of Business Insurance Trusts.--Both business insurance and the business insurance trust, the latter a natural outgrowth of the only slightly older personal insurance trust, though chiefly developments of the past ten years, already are given serious consideration by many large and even many medium-sized concerns. Although their popularity has been somewhat retarded by the depression of the past two years, and although during 1931 and 1932 less propaganda for them was published than in any of the recently preceding years, when the recovery phase of the business cycle has become established, they are likely to make a strong advance in public adoption. The present increased analysis of all business elements, which the depression has enforced, may even of its own accord raise the creation of business insurance trusts to a new peak through an increased appreciation of their benefits and possibilities.

In February, 1929, in a speech delivered at the Tenth Mid-Winter Trust Conference, Paul F. Clark, at that time President of the National Association of Life Underwriters, acclaimed business life insurance as "the greatest single

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1. Pro. 11th, 1930 - p.125
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III. Forms of Business Organizations.--In order to have a sound basis for understanding the value of business insurance trusts to each specific form of business, it is necessary to understand clearly the technical characteristics of each type of business organization. Most businesses come under one or other of the three following heads:

A. Sole Proprietorship.--A sole proprietorship is popularly known as a "one-man business", because in it one individual assumes the entire responsibility for conducting it. He owns all assets, assumes all liabilities, and takes all profits and losses.[2] Although he may be assisted by many employees, some of whom may serve as executives, these have no investment in the business and receive their salaries as

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1. I.T.B. #3 - p.35
2. Simon - p.49,50,51

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1. I.T.B. #3 - p.33
3. Simon - p.49, 50, 51

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B. Partnership.--"A partnership is the relation which results from the association of two or more persons to carry on a business for profit, by virtue of a contract, express or implied, under which the property and profits, or the profits alone, belong to the parties as co-owners."[1] The two chief types of partnership are the general partnership and the limited partnership.

a. General Partnership.--In the general partnership all partners have equal authority and each is liable for the others' acts and for the partnership debts. Among the characteristics of a general partnership are the following:

1. Partnerships may be formed by an express or implied contract between the members. Unlike corporations, they need no State charter.[2]

2. "A partnership must gather all its individual members to sue or be sued."[2]

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1. Parrin and Bubb - Vol.II - p.389,390
2. Simon - p.48,50,51

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4. Each partner may bind all partners, each being individually liable for all the partnership debts when the partnership assets have been exhausted.[2]

5. The death or retirement of a partner automatically dissolves a partnership.[3] This is one of the greatest hazards of partnership. Some agreement, therefore, should be made while all the partners are alive so that at the death of one partner the forced sale of the business at an inadequate price would not be necessary.[4] The surviving partners have three alternatives: winding up the business and paying the decedent's interest to his estate; making an agreement with the heirs and representatives to continue the business; or buying out the decedent's interest.[5]

It should be remembered that if the surviving partners decide to liquidate the business, they themselves conduct the liquidation. They can then incur only such obligations as are necessary to liquidation.[5] However, "the surviving partner is the czar and his judgment is final unless the

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1. Uniform Partnership Act - Section 9. (1)
2. Simon - p.49,50,51
3. Uniform Partnership Act - Section 31
4. I.T.B. #3 - p.17
5. "100 Questions and Answers" - #9, p.12,13

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If life insurance is taken out to render liquidation easy, there should be a collateral agreement, such as a business life insurance trust agreement, to ensure the use of the policy proceeds for that purpose.[1]

b. Limited Partnership.--A limited partnership is one in which one or more special or "limited" partners furnish a given amount of capital to be subject to the risks of the firm, but assume no further personal liability. Every limited partnership must have at least one general partner.

C. Corporation.--"A corporation is an association of persons, organized under the authority of the state, by whose sanction it becomes a legal entity, endowed with capacity of continuous succession, and with power to act in many respects as a single individual."[2] A more famous definition of a corporation, given by Chief-Justice Marshall in the Dartmouth College case, declares: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law."[3]

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A corporation may sue or be sued in its corporate name, and it may make contracts.[5] Ultimate control is vested in

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1. Perrin and Babb - Vol.II - p.435,503,559,502
2. Williams vs. Johnson, 208 Mass. 544.
3. G.L. c.156, Section 4.(a)
4. "The Spectator" - Sept. 17, 1931 - p.10
5. G.L. c.155, Section 6; G.L. c.156, Section 4.(d)

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the stockholders, who have one vote for each share of stock. Corporations are subject to strict regulation by the State. In Massachusetts and New York no corporation may be formed with fewer than three persons as incorporators.[1]

IV. Applicability of Business Insurance Trusts to the Various Forms of Organization.--With these various forms in which any business may be organized clearly in mind let us outline in general terms the possible value of the business insurance trust for each.

1. Sole Proprietorships.--At first glance the sole proprietor's need of a business insurance trust may not be clear; but it is easy to conceive that even a sole owner might welcome some clearly defined and pre-established arrangement for making over the business at his death to his son or to a trusted employee, or for then incorporating the business with a sale of part of the stock to the designated employee. This prearranged procedure, keeping up the business as a going concern after the sole owner's death, would ensure to his family a continued income either from the business itself or from the proceeds of its sale, would eliminate the risk of a forced sale at an inadequate price, and would keep the son or employee vitally interested in the business through becoming its new sole or part owner. In other words, in such a case the value of the business

1. G.L. c.156, Section 6

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1. G.L. c.156, Section 8

insurance trust is founded in the fact that such trusts are "based on the underlying principle that the most successful business is the one which is conducted by co-owners rather than by mere employees."[1]

2. Partnerships.--If the surviving partners, re-establishing the partnership automatically dissolved by their associate's death and continuing the business, admit the heirs of the deceased partner to the active participation in the firm to which the deceased's interest entitles them, there is likely to be friction with these new co-partners, who may totally lack the essential experience. Yet sometimes the surviving partners do not wish to liquidate the entire partnership assets, although they lack sufficient cash to buy in these assets and thus free themselves from further obligation to their deceased associate's heirs. In such a case a business insurance trust agreement, properly drawn before the associate's death, would automatically have called for sufficient insurance on each partner's life to enable the surviving associates to buy out his interest at a satisfactory valuation without straining their resources.[2] Such insurance would be payable to a corporate fiduciary as trustee, and would thereupon be paid over by the trustee to the heirs or representatives of the deceased in return for

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1. I.T.B. #3 - p.4
2. State Street Trust Company - "Business Insurance" - p.7

3. Partnership.--If the surviving partners re-establishing the partnership automatically dissolved by their associate's death and continuing the business, admit the heirs of the deceased partner to the active participation in the firm to which the deceased's interest entitles them, there is likely to be friction with these new co-partners, who may totally lack the essential experience. Yet sometimes the surviving partners do not wish to liquidate the entire partnership assets, although they lack sufficient cash to buy in these assets and thus free themselves from further obligation to their deceased associate's heirs.
In such a case a business insurance trust agreement, properly drawn before the associate's death, would automatically have called for sufficient insurance on each partner's life to enable the surviving associates to buy out his interest at a satisfactory valuation without straining their resources. Such insurance would be payable to a corporate fiduciary as trustee, and would thereupon be paid over by the trustee to the heirs or representatives of the deceased in return for

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1. I.T.B. #3 - p.4
3. State Street Trust Company - "Business Insurance" - p.7

a relinquishment of their rights to the decedent's interest. This relinquishment the trustee would thereupon give to the surviving partners, thus closing the transaction. As a result of such a prearranged agreement, each member of the firm would continually feel secure in knowing that his family would receive the full value of his interest, and that he would run no risk of burdening his surviving partners with an unwelcome outsider as an enforced associate.[1]

A further advantage of business insurance trusts seems particularly important in partnerships where the senior member is growing old and is in poor health; yet apparently no authority has considered the precariousness of a firm which is in this condition. If the younger partners feel that the senior partner's interest must be paid out at his death, they will not only be anxious about his health, but will tend to become over-cautious in all business transactions involving more than a minimum risk. Thus they may easily miss good chances for profit which they would normally seize - and through over-anxiety to keep the concern stable, they may both cause earnings to fall off and allow business to go to "live-wire" competitors from whom they will find difficulty in retrieving it. On the other hand, if the junior partners know that a business insurance trust agreement definitely provides that they will continue the manage-

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1. State Street Trust Company - "Business Insurance" - p.5.

ment of the firm after the senior partner's death, and that they need neither pay off his entire interest nor have his heirs come into the business, they will then be far more likely to have the necessary confidence to take the legitimate risks which every business should take in order to gain a reasonable amount of profit.

3. Corporations.--In a close corporation the situation is essentially the same as in a partnership, except that here the survivors purchase the decedent's stock instead of his partnership interest. It should be noted that in each case the value at which the stock or the interest is purchased is predetermined or the method of valuation is indicated in the business insurance trust agreement.[1]

In the case of a close corporation the stock purchase plan is the provision under a business insurance trust whereby the members of the corporation purchase the stock of a deceased associate. The trust agreement provides that upon each stockholder's death, his stock in the corporation shall be purchased at a given price from his estate with the proceeds of insurance carried on his life by his fellow stockholders. No matter whether the insurance is payable directly to the corporation or to a trustee who pays it to the decedent's estate in return for the shares, there is ultimate delivery of the stock to the corporation in either case.[1]

1. State Street Trust Company - "Business Insurance" - p.13

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Upon receipt of the decedent's shares, the corporation may take action (if the State authorities approve) to reduce its capitalization by the amount of the decedent's stock, and thereupon retire or cancel these shares, or it may continue its authorized capitalization, holding the decedent's shares as treasury stock. The second method is preferable, as this stock is thus left available for re-issue if later desired.[1]

If the stock of a corporation is scattered among numerous holders, it might often prove wiser to take out business insurance on the lives of the "key men" (the important executives) as a "shock absorber" to compensate for the loss which their deaths and the breaking in of new men will undoubtedly cause the corporation.[2]

The stock purchase plan outlined above has nine special advantages.

1. The control of the business by the present management is perpetuated.[3]

2. The risk that the decedent's executor will sell his stock to outside interests is eliminated.[3]

3. Risk of friction with the decedent's heirs is greatly lessened.[2]

4. Surviving stockholders are freed from the "dead hand"

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1. "100 Questions and Answers" - #82, p.75,76
2. State Street Trust Company - "Business Insurance" - p.6,12
3. "100 Questions and Answers" - #60, p.54-56

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2. State Street Trust Company - "Business Insurance" - p.8,13
3. "100 Questions and Answers" - #80, p.54-56

of non-contributory stockholding elements. In a close corporation such a situation is highly important, particularly when considered from the points of view of majority and minority stockholders. Upon the death of a majority stockholder, his shares should not be sold to the detriment of the minority. Likewise if a minority associate dies, the majority owner has at least a moral obligation to the decedent's family. "The minority interest in a close corporation is probably the worst piece of paper in the world. Who will buy it and at what price?" Without a stock purchase plan, the majority stockholder might be forced to buy the minority stock at an inconvenient time (and perhaps at a high price) in order to keep out an undesirable associate.[1]

5. The decedent's dependents are freed from the hazards of that particular business (with such hazards perhaps greatly increased by his death).[2]

6. The decedent's stock is not subject to forced sale at a possible sacrifice.[3]

7. A fair value is placed on the stock by the parties to the agreement, and is kept accurate by periodic statements filed with the trustee.[4]

8. The price agreed to by the associates furnishes a

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1. Manning Manse - 1930 - p.8
2. "100 Questions and Answers" - #60, p.54-56
3. State Street Trust Company - "Business Insurance" - p.12
4. I.T.B. #3 - p.12,13,19

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1. Manning Manse - 1930 - p.8
2. "100 Questions and Answers" - #80, p.84-88
3. State Street Trust Company - "Business Insurance" - p.13
4. I.T.B. #3 - p.12,13,19

valuation basis for appraising the stock for inheritance tax purposes.[1]

9. The execution of the agreement is assured by the use of a corporate trustee.[1]

V. Settlement of Interest Deferred Over a Period of Time.--The agreement may also provide a definite arrangement whereby the decedent's heirs will receive any remaining portion of his interest over a period of time, if the insurance is insufficient to pay the full amount. In the case of a corporation, the decedent's stock is held by the trustee until this interest is fully paid.[2]

VI. Purposes of Business Insurance Trusts.--Mr. Simon in his "Business Insurance" has set forth eight chief purposes of business insurance trusts in general, as applicable to one or to all of the possible forms of business organization.[3]

1. To enable the sole proprietor of a business
   a. to pass on to his employees all or a substantial part of his business at his death;
   b. to bind to the business a key employee as manager;
   c. to assure to a beneficiary who is still a minor the opportunity of a controlling interest at majority if later desired;

1. I.T.B. #3 - p.12,13,19
2. "100 Questions and Answers" - #60, p.54-56
3. Simon - p.27,28

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1. I.T.B. #3 - p.18,19,19
2. "100 Questions and Answers" - #60, p.54-58
3. Simon - p.37,38

2. To enable the surviving partner or partners to acquire the interest of a deceased partner;

3. To enable a close corporation or the surviving stockholders to purchase or retire the shares of deceased stockholders;

4. To compensate for loss of service through the death of a valuable officer or employee;

5. To protect or strengthen the credit of the concern;

6. To act as a sinking fund for the ultimate payment and retirement of a bond or note issue;

7. To retire the interest of a living associate by using the cash surrender value of the insurance policies upon his reaching a given age;

8. To serve as an emergency fund by using the cash values of the insurance policies in case the business requires resources in excess of its credit capacity.[1]

These eight purposes of business insurance trusts are self-evident in their value to business; the aim of all eight may well be summarized as the intelligent employment of "business insurance trusts to remove hazards".[2]

VII. Essential Qualifications for Successful Underwriters.--One fact which stands forth clearly regarding every business insurance trust is that it is a highly tech-

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nical contrivance whose proper functioning must depend to an almost inconceivable degree upon the good sense and the knowledge of those who create it - and perhaps most of all upon the wise advice of the man who probably initiates the idea - i.e. the underwriter who "sells" the project to the business organization. This being so, it is no wonder that a number of books, speeches, and articles on business insurance contain suggestions and instructions for the underwriter. I have yet, however, to see in print a single statement of three highly important and, it would seem, self-evident qualifications for a successful writer of business insurance and business insurance trusts. The first of these is a sound and thorough accounting training, which has developed the ability to interpret financial statements and the ability to appraise intelligently the intangible element of Goodwill. Such training would be invaluable in coöperating both with the firm and with the prospective trustee to determine the true value of the business and of each associate's share in it. The second essential and equally important qualification is a sense of proportion concerning the human elements in the case. The third essential qualification is a sound and kindly judgment in neither overburdening with insurance nor under-protecting either the business as a whole or each associate's share in it. This last requirement - so difficult to meet - should be reenforced by periodical reviews

of the current conditions in each line of business approached by the underwriter.

VIII. Forty-Seven General Problems Presented by Average Cases.--Assuming, then, that the underwriter, a well-trained, kindly man of sound judgment, has succeeded in convincing an organization that it will profit by creating a business insurance trust and by placing it in the hands of an experienced corporate fiduciary, let us consider what problems lie ahead of these three coöperating creators of the trust agreement. It is clear that many, many points must be weighed and determined before such an agreement can be drawn up with the true "meeting of minds" which the law requires. I shall list, with a brief discussion of each, forty-seven of the chief problems. Not every case will present all of these, but every average case will present a majority of the forty-seven, and some cases would probably present points not even touched upon here.

A. TAKING OUT THE POLICY

1. Which life or lives shall be insured?--The policies should be taken out on the lives of those whose death will mean some appraisable loss to the business. These persons will differ both with the type of business and with the relative values of the individuals in the individual company. Thus the insurance may be taken on the sole proprietor, on the partners in a partnership, on some or all of the stock-

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holders in a close corporation - in general, on the "key men" in any business.

2. To what amount shall the insurance be taken out? Is this adequate for the purpose?--The amount of insurance depends entirely on the size and value of the business, on the value of the interest of each member insured, and on the value of this member to the organization. It is exceedingly important that this insurance reserve should be adequate, so as to avoid the drain on the concern's resources which insurance is intended to nullify. On the other hand the business should not be overinsured and thus penalized by unnecessarily large premiums and embarrassed at the death of an associate by surplus insurance which must be divided among the members of the organization. Moreover the agreement should provide that if at the time one member dies, the net assets of the business have increased since the original business insurance was taken out - so that the proceeds of his insurance now prove insufficient to pay the full value of the deceased associate's interest in the concern - the surviving associates may pay up the required balance over a given period of time. Such payment should be made by notes payable to the decedent's estate and secured by real or personal property of the surviving associates. The agreement may similarly provide that if the insurance fund is larger than the value of the decedent's interest at the time of his

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death, the excess will be turned over to the surviving members by the business insurance trustee[1] - or, if preferred, divided proportionately among the surviving members and the deceased's estate. The surest and wisest way to render such adjustments unimportant and even unnecessary obviously is to make a periodical review of existing business conditions and of the outlook for the immediate future, and to revise the amount of business insurance carried to suit the current requirements.

While deciding the amount of insurance to be carried in a close corporation, the creators of the agreement must guard against one highly important liability of each man insured - that is, the personal endorsement of corporation paper (i.e. notes) by key men. Most trust companies have never considered this.[2] Because such a liability holds against the endorser's estate, it would also hold against the insurance proceeds if they were payable to his estate. In any case, the insurance should be regulated to allow for this liability and to keep it from being too great a drain upon the decedent's estate.

3. What method shall be followed to fix the value of the stock or the partnership?--Several methods are commonly used in valuing a business or a deceased associate's interest in it.

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1. I.T.B. #3 - p.19
2. Manning Manse - 1929 - p.30

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1. I.T.R. #3 - p.19
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a. The book value method takes the value of the business shown by the books as of a given date, which is usually either the date of death of one associate or the end of the last fiscal period. This book value is determined from the actual accounting records by a C.P.A. or an appraisal company, usually named in the business insurance trust agreement as the authority appointed to fix the price. This method, however, risks overlooking several important accounting elements. The company may be carrying assets on its books at too high or too low a value, it may have omitted to write off sufficient depreciation, its reserves may be too high or too low, or it may, as frequently happens, have ignored or minimized Goodwill - often an important earnings factor and therefore essential to the proper valuation of an interest in the concern.[1]

b. Appraisal by three appraisers or "arbitrators" is a method occasionally used. One appraiser should be appointed by the decedent's executor or administrator, one by the company or its surviving members, and one by the trustee or by the two appraisers already appointed.[2] The agreement should provide that the probate court may appoint such arbitrators if any of these three refuse

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2. "100 Questions and Answers" - #43, p.41, 42

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c. Capitalization of average net earnings over a given period of years at an agreed rate may be accurate for some concerns. In non-accounting language this means that the earnings for five years are averaged and the figure obtained is considered to represent some arbitrary percentage earned on the total principal (perhaps 7%), and is taken as the key-figure for calculating the total 100% of the net worth of the business. This method needs a thorough testing by the individual company before it is incorporated in the business insurance trust agreement. It must also be adjusted to meet the wishes of the various parties concerned. It should never be applied blindly or by a new business.[3]

d. "Book value plus Goodwill" is somewhat like "capitalization of average net earnings". A figure for Goodwill is reached by one of the methods to be

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1. "100 Questions and Answers" - #43, p.41,42
2. "100 Questions and Answers" - #48, p.45
3. "100 Questions and Answers" - #49, p,46,47

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1. "100 Questions and Answers" - #43, p.41, 42
2. "100 Questions and Answers" - #43, p.45
3. "100 Questions and Answers" - #43, p.46, 47

described under the next main heading (Problem 4). This amount is then added to the book value to obtain the value of the business.[1] Like the "capitalization of net earnings" method, this must be thoroughly tested before it is named in the trust agreement. Such a test is necessary on account of the capitalization of earnings in finding Goodwill.[2]

e. By a <u>combination of methods</u>, if a mathematical formula for valuing the business is desired, it is usually best, however, to provide in the business insurance trust agreement that the value of the decedent's interest shall be the highest amount obtainable by applying the "capitalization of average net earnings" and the "book value plus Goodwill" methods separately. Often the associates will state in the agreement that any excess of insurance proceeds over this highest figure shall also go to the decedent's estate as part of the purchase price of his interest. It has been suggested as fairer, however, that the estate should receive the mean between the highest and the lowest prices instead of getting the benefit of the entire difference.[3]

f. <u>Periodical valuation by mutual consent of the parties</u> is probably the best and most nearly accurate

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1. "100 Questions and Answers" - #43, p.41,42
2. "100 Questions and Answers" - #50, p.47,48
3. "100 Questions and Answers" - #51, p.48,49

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1. "100 Questions and Answers" - #43, p. 41, 42
2. "100 Questions and Answers" - #80, p. 47, 48
3. "100 Questions and Answers" - #81, p. 48, 49

method. The members of the concern mutually agree upon some given sum as representing the true value of the business, and provide in the business insurance trust agreement that they will revise this amount every six months or every year to fit changing conditions.[1] The agreement also states that if the parties have neglected the periodical revision of the price so that it has not been fixed within a given period before the death of one of the members, three appraisers shall be appointed to adjust the last price named and bring it into line with conditions as of the decedent's death.[2] As in the "appraisal" method, one of these shall be appointed by the estate, one by the surviving members, and one by the trustee. Such a determination of the value of the business and of the price to be paid by each associate, made while all members of the organization are alive, has indisputable advantages of fairness and saving of later rancor and discussion for all concerned.

It should be noted that state and Federal tax authorities will probably accept the valuation of the business stated in the business insurance trust agreement. "What better evidence of the value of the decedent's estate could be had than a contract entered into by all the parties interested in the

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2. "100 Questions and Answers" - #44, p.42,43

method. The members of the concern mutually agree upon some given sum as representing the true value of the business, and provide in the business insurance trust agreement that they will revise this amount every six months or every year to fit changing conditions.[1] The agreement also states that if the parties have neglected the periodical revision of the price so that it has not been fixed within a given period before the death of one of the members, three appraisers shall be appointed to adjust the last price named and bring it into line with conditions as of the decedent's death.[2] As in the "appraisal" method, one of these shall be appointed by the estate, one by the surviving members, and one by the trustee. Such a determination of the value of the business and of the price to be paid by each associate, made while all members of the organization are alive, has indisputable advantages of fairness and saving of later rancor and discussion for all concerned.

It should be noted that state and Federal tax authorities will probably accept the valuation of the business stated in the business insurance trust agreement. "What better evidence of the value of the decedent's estate could be had than a contract entered into by all the parties interested in the

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1. "100 Questions and Answers" - ¶43, p. 41, 42
2. "100 Questions and Answers" - ¶44, p. 42, 43

business when all are alive and anxious to protect their respective estates?" The contract which binds the decedent's estate and all other interested parties should also bind the state and Federal governments.[1]

4. How is the Goodwill to be figured?--Goodwill should always be considered by those creating a business insurance trust.[2] The trust agreement should specify whether or not Goodwill is to be counted as an asset in determining the value of a decedent's interest. The agreement should also state either the exact amount of Goodwill (if it is to be used as an asset) or the exact method for its determination.[3]

In the first place, there is the arbitrary fixed-sum method of stating Goodwill, whereby the associates assume that Goodwill may be represented by a certain amount which may have no practical justification on the books of the organization. For more reliable estimating, there are three common accounting formulae used in calculating Goodwill:[4]

a. Purchase of Given Number of Years' Profits

Formula:

Average Profits x Number of Years = Goodwill

b. Capitalization of Net Profits

Formula:

$$\frac{\text{Average Net Profits}}{\text{Rate of Capitalization}} - \text{Net Assets} = \text{Goodwill}$$

1. "100 Questions and Answers" - #37, p.37
2. "100 Questions and Answers" - #52, p.50
3. "100 Questions and Answers" - #43, p.41,42
4. LaSalle - "Principles of Accounting Practice" - Assign. 10, p.21

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1. "100 Questions and Answers" - #37, p.37
2. "100 Questions and Answers" - #52, p.50
3. "100 Questions and Answers" - #43, p.41, 42
4. LaSalle - "Principles of Accounting Practice" - Assign. 10, p.21

To express this method less technically: the average annual net profits covering a period of at least five years is considered to represent a given percentage of the total value of the business. This percentage (often 15%) is taken as the key-figure for determining the total 100% of the net worth of the business. When the actual assets have been subtracted from this figure, the net result represents the Goodwill.

c. Capitalization of Excess Net Profits[1]

Formula:

$$\frac{\text{Average Net Profits - Fixed Rate on Net Assets}}{\text{Rate of Capitalization}} = \text{Goodwill}$$

To express this method less technically: after a fair return (often 7%) on the invested capital (or "book value") is taken out of the average annual net profits covering a period of at least five years, the balance of the average annual net profits is considered to represent the return earned by the Goodwill. The percentage of Goodwill which this balance is considered to represent (often 15%) is taken as the key-figure for determining the total 100% of the value of the Goodwill.

Any method of capitalization based on Goodwill "should always be tested from at least two possibilities regarding future earnings:[1]

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Any method of capitalisation based on Goodwill "should always be tested from at least two possibilities regarding future earnings:

1. Lasalle - "Principles of Accounting Practice" - Assign. 10, p.21

"a. Net Profits maintained at the average shown by past operations.

b. Net Profits increased over the average of past operations by an estimated per cent."[1]

There is also a third possibility:

c. Net Profits decreased from the average shown by past operations.

This statement is made because future outlook, as well as past achievement, should be considered in determining Goodwill.

5. What effect will the insurance itself have on the value of the business?--Insurance cash values or maturity values are not included in valuing the business interest of a deceased member of the organization. Such insurance amounts are "trust assets" for use in purchasing that interest - not general assets for business purposes.

The question is frequently raised as to the advisability of showing the cash or maturity values of business insurance in an organization's periodical financial statements. A recent court ruling declares that in cases where the individual members of the concern pay the premiums, the cash values need not be carried in the financial statement. If the business itself pays the premiums, the cash values of the insurance may be carried as an asset in the balance sheet.[2]

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2. Boston Life Insurance Trust Council Notes

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1. Easelle - "Principles of Accounting Practice" - Assign. 10, p.81

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The maturity values should not be shown in the statements. It would be well, of course, to have a memorandum entry on the books of the business showing the maturity values for reference purposes - and if the parties preferred, it would be possible to show these values as a footnote to the balance sheet, although such a procedure would be unnecessary.

6. Is the amount of insurance to remain stationary or to be automatically increased at appointed intervals?--The amount of insurance should be periodically reviewed, and increased as the value of the business increases. It should not be automatically increased without regard to business conditions. For instance, the insurance might have been increased each year in 1927, 1928, and 1929, but it should have remained stationary or even decreased, with part of the insurance cashed in, in 1930, 1931, and 1932. Any business insurance trust agreement written before the latter part of 1929 and providing for automatic annual increases in insurance would have caused the majority of businesses to be absurdly overinsured by the close of 1932.

7. What allowance should be made for changes in stock ownership which affect the amount of insurance?--The amount of insurance should be changed to conform to the new conditions, and likewise the premiums paid by each stockholder should be changed to conform.

8. What type of policy shall be used?--

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8. What type of policy shall be used?--

a. Straight life or "ordinary life" policies are usually sold where the members of the organization want the greatest permanent protection for the least outlay. This type of policy is the one most likely to appeal in cases where the associates are growing old.[1]

b. Limited payment life policies, under which the insured pays for a definite number of years (usually twenty) and is then insured for the rest of his life with no further payments required, are often sold when the business insurance prospects are young, because this type of policy has a relatively high cash value, which may be considered in the future as an emergency fund in case of need.[1]

c. Term insurance, an inexpensive type of insurance for a short term of years (usually five) with privilege of conversion into one of the other types of insurance, is seldom used, but it may have value where the business may continue for only a short time. The businesses where term insurance has been tried have not ordinarily found it really satisfactory. Few term policies are converted to a more permanent form; most either lapse soon or are allowed to expire at the end of the term period. For this reason "comparatively few death claims are paid on term insurance policies".[1]

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1. Simon - p.37,38,39,40

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d. Endowment insurance, whereby premiums are paid for a specified number of years (usually ten, twenty, or thirty years) and at the end of that time the insured automatically receives the face value of the policy, is sometimes written to retire the individual members of the concern at a given age. Another occasional use of endowment insurance for business purposes is the retirement of a bond issue of a large corporation, particularly where the business of the company has been built around the president's personality. The insurance is written for the period of duration of the bond issue, with the provision that the president's death prior to the expiration of that period will automatically make the bonds redeemable by the company. If the president survives to the end of the period, the corporation will receive the insurance proceeds and will use them to retire the bond issue.[1]

9. Shall new or existing policies be used?--One authority has said: "My judgment is that in business insurance trusts, in the majority of instances, new life insurance should be taken out."[2] This statement is primarily based on the idea that a man's existing policies have been taken out for the protection of his family apart from the business,

1. Simon - p. 39,40
2. Pro. 13th - 1932 - p.90

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1. Dimon - p. 39, 40
2. Pro. 13th - 1923 - p.80

and that such policies should continue to be held independently of all considerations of the business as such. However, in practical application, old policies may be used as well as new ones and it is even perfectly feasible to set up a business insurance trust by using only previously issued policies. When using old insurance, however, the trust creators should make sure that the manner in which the policies are brought under the trust agreement will not cause any avoidable complications or tax disadvantages.

Old insurance policies may have been taken out by one associate on himself or by the organization on him, or may have previously been transferred by the insured to the business. The trustee must be able to collect such policies immediately upon the insured's death. The policies must be placed beyond the control of the insured so that he cannot change his mind (or be forced by his creditors to change it) and withdraw these policies for cancellation.

10. What shall be done when one member of the firm is uninsurable?--If one member of the firm is uninsurable, the agreement should provide for a separate sinking fund to help retire his interest. The other associates should agree to make periodical payments to this sinking fund at the time when they pay the insurance premiums on the insurable lives. They should make those payments, as a minimum, equal to the premiums which they would have paid on his life if he had

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been insurable. In some cases, indeed, they may be willing to make such payments equal to short-term endowment premiums, on the theory that they would have taken out that type of policy on his life if possible. The agreement should also provide specifically for the payment at the death of the uninsurable member of the balance of his interest, particularly if he dies soon after the sinking fund is started. The other associates, of course, should be protected by business life insurance in the usual way.

11. Who shall apply for the insurance?--The one who applies for the insurance and pays the premiums is known as "the one who carries the insurance". He may not be the one on whose life the policy is written. Indeed, if a man took out business insurance on his own life, then his own money (the insurance proceeds) would be used at his death to buy out his own business interest for the benefit of his surviving associates, while he would have no share in the insurance on their lives.[1] One authority says plainly: "The objection to insurance payable to the purchaser is that it brings about a contradictory premise involving the purchase of one's own interests in favor of his associates, together with a complication in the question of reimbursement to the decedent for premiums paid by him on the lives of his surviving partners."[2]

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1. "100 Questions and Answers" - #74, p.70
2. "The Boston Anchor" - June, 1930 - George E. Coates: "Functions of Business Life Insurance"

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1. "100 Questions and Answers" - WVA, p.70
3. "The Boston Anchor" - June, 1930 - George E. Doates: "Functions of Business Life Insurance"

If the insurance is to be carried by other than the insured, there must be an insurable interest. This question will be considered fully under Problem 12 of this section.

Before a corporation arranges for a business insurance trust, a resolution should be passed by all the directors and also by all the stockholders authorizing the corporation to carry insurance and to buy the stock.[1] This resolution should include "the application for insurance, the corporation's agreement to pay the premiums, and its obligation to use the insurance proceeds to buy the deceased stockholder's shares or to have a trustee do so in its behalf. With the executed copy of the insurance trust agreement there should be a certified copy of the stockholders' resolutions, under seal."[2] Such a resolution will help the corporation to avoid any complaint from stockholders or creditors that they lack authority to carry insurance or to buy their own stock.

A further discussion of this problem with particular reference to the carrying of insurance and the payment of premiums by corporations of all types will be found under Problem 16 of this section.

12. Is there an insurable interest?--The legal definition of "insurable interest" is as follows:[3] "Stated con-

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1. I.T.B. #3 - p.6
2. "The Boston Anchor" - June, 1930 - George E. Coates: "Functions of Business Life Insurance"
3. Corpus Juris - Vol. 37, p.391,393

If the insurance is to be carried by other than the insured, there must be an insurable interest. This question will be considered fully under Problem 18 of this section.

Before a corporation arranges for a business insurance trust, a resolution should be passed by all the directors and also by all the stockholders authorizing the corporation to carry insurance and to buy the stock.[1] This resolution should include "the application for insurance, the corporation's agreement to pay the premiums, and its obligation to use the insurance proceeds to buy the deceased stockholder's shares or to have a trustee do so in its behalf. With the executed copy of the insurance trust agreement there should be a certified copy of the stockholders' resolutions, under seal."[2] Such a resolution will help the corporation to avoid any complaint from stockholders or creditors that they lack authority to carry insurance or to buy their own stock.

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18. Is there an insurable interest?--The legal definition of "insurable interest" is as follows: "Stated con-

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1. I.T.B. #3 - p.8
2. "The Boston Anchor" - June, 1930 - George E. Doates: "Functions of Business Life Insurance"
3. Corpus Juris - Vol. 37, p.581,582

cisely, an insurable interest in the life of a person is an interest in having the life continue; a person has an insurable interest in the life of another where there is a reasonable probability that he will gain by the latter's remaining alive or lose by his death. Stated more comprehensively, an insurable interest exists where there is reasonable ground, founded upon the relations of the parties to each other, either pecuniary or contractual or by blood or affinity, to expect some benefit or advantage from the continuance of the life of the insured."[1]

As to the extent of an insurable interest, the law states: "While some courts have been inclined to limit the amount of the insurance to the actual pecuniary interest, the general inclination seems to be to support the policy although the amount of the pecuniary interest is less than the amount of the policy, unless the interest is so proportionally small as to show the contract to be a mere wager."[1]

Because the person who pays the premiums carries the insurance, it is necessary to consider whether this person who pays possesses an insurable interest in the insured.[2] This question does not arise if each person pays the premiums on his own insurance, because he can then have it made payable to anyone he chooses, even if the beneficiary has no

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1. Corpus Juris - Vol. 37, p.391,393
2. I.T.B. #3 - p.5

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1. Corpus Juris - Vol. 37, p.381, 382
2. I.T.B. #3 - p.8

insurable interest in his life. However, as stated above, if the insurance is carried by another, then that other's insurable interest must exist.[1]

"The courts have decided in many cases that partners have an insurable interest in the lives of their co-partners. It has also been decided and is universally admitted that corporations have an insurable interest in the lives of their officers and employees. The reason for this is not because they are officers or employees per se but because they are of value to the corporation." A stockholder who is not an officer may be of even greater value to a corporation than one of its officers, as his standing may give the corporation credit, and he may guarantee its obligations; in short, the corporation is benefited in many cases by his ownership of its stock.[1]

Similarly in a close corporation if one or more stockholders carry insurance on each other's lives, the question of insurable interest is much the same as in a partnership. Where a small group of men embark in a business in which all take an active interest, it makes no difference whether they form a corporation or a partnership as far as their mutual interest in each other's lives is concerned.[1]

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with the management, the corporation has no insurable interest in the lives of these public stockholders and does not attempt to establish a business insurance trust to replace their value.[1]

Other closely-allied phases of this question with regard to the application for insurance and the payment of premiums are discussed in Problems 11 and 16 of this section.

13. Must an interest continue insurable in order that the insurance may continue?--A Massachusetts court has decided: "An insurable interest in the assured at the time the policy is taken out is necessary to the validity of the policy, but it is not necessary to the continuance of the insurance that the interest should continue; if the interest should cease, the policy would continue and the insured would then have an insurance without interest."[2] Another authority has summarized this general rule more briefly: "If the insurable interest is valid at inception, then it is always valid."[3]

14. Shall the insurance be applied for by the insured and then assigned?--Sometimes it may be well to apply for the insurance policies at the beginning of the negotiation for a business insurance trust, so that the business will be protected while the details of the trust agreement are

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1. I.T.B. #3 - p.5
2. Mutual Life Insurance Co. vs. Allen (139 Mass. 24,26)
3. Simon - p.390

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1. I.T.B. #8 - p.8
2. Mutual Life Insurance Co. vs. Allen (139 Mass. 24,28)
3. Simon - p.380

being worked out. When the agreement is complete, the insurance policies are then made payable to the beneficiaries designated by the agreement.

It is impossible to say offhand whether an assignment or a change of beneficiary is the better method in making policies payable to the beneficiary under a business insurance trust agreement. In each case the provisions of the agreement itself and of the individual policies must be studied before arriving at a conclusion. One authority says: "We recommend, in a good many cases, a combination of change of beneficiary and assignment, because of the decisions in a number of courts that where the insured has reserved the right to change the beneficiary in a life insurance policy, he cannot defeat the interest of the beneficiary except in the manner set forth in the policy. In other words, upon the death of the insured, a named beneficiary who has not been changed will take the proceeds, even though the policy has been fully assigned to another before the death of the insured."[1]

15. Does the trust agreement conflict with other documents?--If a partnership is concerned, "particular care should be taken in every case to see that none of the provisions of the trust agreement conflict with the articles of copartnership, or with any other outstanding agreements

1. "100 Questions and Answers" - #63, p.58,59

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1. "100 Questions and Answers" - #83, p. 38, 39

between the partners. If a corporation, its charter and by-laws should be examined for the same reason."[1]

B. PREMIUMS

16. Who is to pay the premiums?--In a sole proprietorship, "if they are able to do so, the insurance should be carried and the premiums paid by the employees who are going to purchase the business, or a substantial interest therein, from the proprietor or from his estate. In many cases a common fund will be established to which both the owner and the employees contribute - the owner's contribution being in lieu of higher salaries, bonuses, or other plans."[2]

In the case of a partnership or a corporation, either (a) the partnership or corporation itself pays the premiums, (b) each partner or stockholder pays the premiums on his own insurance, or (c) the partners or stockholders pay the premiums on each other's insurance.[3]

The objection to having each individual pay the premiums on his own insurance has already been given under Problem 11 in this section. It holds true alike in sole proprietorships, partnerships, and corporations. This method seems to be the poorest of the three.

The plan (a) of having the partnership itself pay the premiums is more convenient than having each partner pay a

1. "100 Questions and Answers" - #58, p.54
2. "100 Questions and Answers" - #17, p.22,23
3. I.T.B. #3 - p.5

between the partners. If a corporation, its charter and by-
laws should be examined for the same reason."[1]

B. PREMIUMS

16. Who is to pay the premiums?--In a sole proprietor-
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1. "100 Questions and Answers" - #58, p.84
2. "100 Questions and Answers" - #17, p.82,83
3. I.T.B. #3 - p.5

proportionate share of the insurance on his associates' lives. All the partners must agree to having the partnership pay the premiums in order to have this method adopted. The firm creditors, however, may be able to reach the insurance proceeds; and part of the proceeds may be subject to the Federal estate tax as forming part of the deceased partner's estate.[1]

The third plan (c), where each partner or stockholder carries his proportionate share of the insurance on his associates' lives, is the best method if there is no other business insurance already in effect. In a corporation this plan places the insurance proceeds beyond the reach of creditors.[2]

In a close corporation there are two important arguments in favor of having each stockholder insure the lives of the others. The first argument is that in a few states corporations cannot buy their own stock. The second is that life insurance on which the premiums are paid by others than the insured would be exempt from tax on the insured's death. "If the corporation applied for the insurance and paid the premiums, and was the beneficiary of the policy, it would result indirectly in the insurance being subject to tax on the death of one of the stock-

1. "100 Questions and Answers" - #15, p.19,20
2. "100 Questions and Answers" - #16, p.20,21,22

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1. "100 Questions and Answers" - #15, p.18,30
2. "100 Questions and Answers" - #16, p.20,21,28

holders."[1] Moreover, if the insurance proceeds were in excess of the amount to be used to purchase the stock, this excess might be disbursed "in the form of a dividend which in the hands of the recipient would be subject to surtax."[1] A corporation has no right to carry insurance on the lives of even its principal stockholders and to pay the premiums if the proceeds are payable to a corporate trustee to be used under a business insurance trust agreement in purchasing the decedent's shares for the surviving stockholders. "The corporation would have no authority to pay out its funds solely for the benefit of its stockholders, and its agreement to do so would be ultra vires."[2] The same would be true if the proceeds are payable directly to the surviving stockholders under an agreement binding them to buy and the decedent's estate to sell.[2]

But if the proceeds are payable to the corporation itself under an agreement whereby the corporation will use them in purchasing and retiring the decedent's stock, or if the proceeds are payable to a corporate trustee under a business insurance trust agreement to be used by the trustee in purchasing the decedent's stock and delivering it to the corporation for retirement, then the corporation may carry the insurance and pay the premiums from corporate funds if

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1. I.T.B. #3 - p.15
2. "100 Questions and Answers" - #14, p.17,18

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1. I.T.B. #3 - p.15
2. "100 Questions and Answers" - #16, p.17,18

the corporation can reasonably be said to suffer a loss through the death of the insured stockholder.[1]

"If the insurance carried does not exceed the loss which the corporation suffers through the death of the insured, then the corporation would certainly have the right to pay for the insurance out of corporate funds because it is merely protecting itself against a known possible loss."[2] The stockholders would not complain that the insurance "was excessive and was unduly depleting the corporate assets,"[2] because they would all have assented to the insurance trust. The creditors could not complain as long as the insurance was paid out of earnings. Moreover, because the cash surrender value of the insurance is an asset to the corporation, the creditors are in a better position if earnings are used to pay insurance premiums than they would be if the earnings were distributed as dividends.[2]

Other cases in which the corporation should <u>not</u> be a party to the trust agreement and should not carry the insurance are:[3]

a. The majority stockholders wish to exclude certain minority stockholders from the benefits of the transaction. (The trust agreement should then be between the corporate trustee and the individual majority

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1. "100 Questions and Answers" - #14, p.17,18
2. I.T.B. #3 - p.5
3. "100 Questions and Answers" - #16, p.20,21,22

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2. I.T.R. #3 - p.5
3. "100 Questions and Answers" - #16, p.20, 21, 22

stockholders only.)[1]

b. The laws of the incorporating state forbid the corporation to buy and hold its own stock, or restrict it so as to jeopardize the plan.[1]

17. Shall the policies contain a provision for an automatic loan to pay the premiums?--Because the payment of the premiums is one of the most serious duties in a business insurance trust, the trustee must be able to make certain that all are paid. It has been suggested that the policies should contain the provision that in case of non-payment of premiums, the insurance company should make an automatic loan on the policy for that purpose. This suggestion should be considered when taking out the insurance.

18. What shall be the dates and amounts of the contributions to the premium fund?--In planning a business insurance trust, it is exceedingly important to use care in arranging the dates and amounts of premium payments, particularly where some of the policies are old ones. If possible, payments should come when the associates are most likely to have plenty of cash on hand - such as the end of the most profitable business season of the year. Sometimes, however, it may be well to "stagger" the payments over several months, or even to provide for semi-annual instead of annual payments. The entire situation should be considered with regard to the individual business.

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1. "100 Questions and Answers" - AIA, p.30,31,32

19. How can premiums be equalized when the ages of the insured are different?--"It is easy to make an equalization of the premiums during the life of the partners, but at the death of one of them, what effect does that equalization of premiums (paid by the individual, not the firm) have upon the respective rights of the estate and the surviving parties in making an equitable adjustment?"[1] This question was raised at the Tenth Mid-Winter Trust Conference in 1929. The reply then given in the general discussion seems so absurdly fallacious, when applied to actual life, that it is difficult to see how "hard-headed business men" allowed it to go unchallenged; yet I have read similar statements in authoritative books on this subject. The answer was: "Let us assume that A is 60 and B, the other partner, is 30. We will also assume a disparity of interest. If A purchases the interest on B, and B on A, each one is furnishing his own funds, in the event of the death of the other, to purchase his interest and is going to get a corresponding benefit. Furthermore A, who pays the lesser premium on B, presumably will pay for a longer time because B is a younger man; B, who pays on A, pays a higher premium but presumably for a shorter time based on expectancy. Theoretically it is going to adjust itself."[1]

But although theoretically A's premiums on B's life and B's on A's life may thus equalize themselves, it should be

1. I.T.B. #3 - p.39

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1. I.T.B. #3 - p.30

remembered that shrouds lack pockets and that ghosts cannot pay premiums - unless they use some sort of ghostly currency, which would not be recognized as legal tender. Hence how is it logically possible to say, as more than one authority has tried to say, that A, the older man, who pays at a low rate on B's life, will have to pay for a longer time than B will have to pay at a high rate on A's life, because A will die first? For how can A keep on paying B's premiums after A dies? Is it wise for an underwriter to make such a preposterous claim in attempting to explain to a client how premiums may be equalized?

However, in commonsense practice, where the insurance is carried by individuals on their associates' lives, and where the ages of the insured differ, there is a plan whereby "the premiums are paid out of a permanent fund and charged against the other parties on the basis of equal proportions."[1] In other words, if the parties concerned plan to equalize the premiums, although theoretically each buys the insurance on the other's life, they establish a common fund from which the premiums are paid. Then at the death of A, who has a one-half interest in the firm, A's estate is reimbursed for one-half the premium outlay which the partners have made.[1] A's heirs, of course, ultimately via the trustee receive the insurance proceeds, whereas the surviving partner, B, takes

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1. I.T.B. #3 - p.39

over the business and the insurance policy on his own life. That method "immediately equalizes any difference in ages because it reimburses A to the extent of what he gave up - 50% of the net premium outlay."[1]

The point of view of another authority, who claims that reimbursement to the decedent's estate of premiums which the decedent had actually paid on the policies on the surviving associates' lives will wipe out any apparent inequality, will be considered under Problem 23.

20. What would be the consequences of the failure of one or all to pay the premiums?--Such failure should be carefully provided for in both the trust agreement and the provisions of the policies themselves. Usually the latter each contain a provision for automatic premium payments, drawn from the cash value of the policy, in case of defaults, and allow six months' grace to the defaulter before the insurance lapses. Beyond or in lieu of such protection the trust agreement should provide for loans from the other associates for purposes of premium payments in emergency.[2] The trust agreement should also state that if the insurance of one party, because automatic premium payments have been deducted, should fall below a given figure, the other parties may, if they wish, terminate the agreement by filing a written statement with the trustee, who thereupon would make

1. I.T.B. #3 - p.39
2. I.T.B. #3 - p.23

1. I.T.B. #3 - p.39
2. I.T.B. #3 - p.33

over all the insurance policies to their respective owners.[1]

21. What right would other parties have to pay premiums in lieu of a defaulter?--The business insurance trust agreement should provide that if one party defaults his premiums, the others should be allowed to pay them for him. In such a case, the shares in the proceeds of those paying the defaulter's premiums should be equitably adjusted.

22. Should a defaulter be reinstated? On what terms?--The agreement should mention whether a defaulter is to be reinstated. If he is to be, he should repay the defaulted premiums with interest.

23. Should there be reimbursement for premium outlay?--In all there are three methods of arranging about the refund of premiums. The premiums may be considered as expense, and not refunded when one party dies; the surviving associates may completely refund to the decedent's estate the premiums which he paid during his lifetime; or some plan may be worked out for using proportions of the cash surrender values of the policies.[2]

If the organization pays the premiums, the decedent's estate is entitled to reimbursement of a percentage of the total premiums paid equal to the percentage representing his interest in the business.[3] Otherwise, by giving up his

1. I.T.B. #3 - p.23
2. Pro. 11th - 1930 - p.131
3. "100 Questions and Answers" - #72, p.67-69

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1. I.T.R. #3 - p.33
3. Pro. 11th - 1930 - p.131
3. "100 Questions and Answers" - #13, p.67-68

right to a distribution of earnings to that extent, he has contributed to purchasing his own business interest for the survivors' benefit.[1]

On the other hand, if each individual associate joins in paying premiums on the others' lives or contributes to a common fund for that purpose, no member contributes anything toward the insurance on his own life, but each has a share in the cash values of the policies on the lives of the other parties to the extent of each one's contribution to the premiums.[1] The survivors should reimburse the decedent's estate for such cash values, and should receive in return the policies or the decedent's interest in them.

One authority, Mr. Gwilym A. Price, says: "It seems to me that the best method in a close corporation would be to provide for the refund to the decedent of his proportionate share of the premiums paid and not just the cash surrender value of the policies and not to treat it as an expense which has been wiped out. Of course, when you go to work out a particular agreement, that is a matter for the parties themselves to decide after the three viewpoints have been presented to them."[2]

The reimbursement to the decedent's estate for premium outlay which he made during his lifetime may seem too annoying and unnecessary a provision to be incorporated in the

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2. Pro. 11th - 1930 - p.131

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1. "100 Questions and Answers" - BTS, p.87-88
2. Pro. 11th - 1930 - p.191

trust agreement. However, such reimbursement of premiums may go far to wipe out an apparent inequality of interest among associates. For instance, a business worth $150,000 is owned equally by three men, each insured for $50,000 of business insurance. At the death of the first partner, his estate receives $50,000 insurance. In this case there is no reimbursement for premiums. The two surviving partners then own the entire business; therefore the insurance on each is increased to $75,000. Six months later one of these two partners dies. His estate receives $75,000 insurance. Thus, of the three equal partners, the estate of the first to die receives $50,000, and the estate of the second $75,000, while the surviving partner becomes sole owner of the $150,000 business. Such a situation hardly seems fair. Yet it is claimed that "this is the chance which all three take, and it is as fair for one as for another."[1] As a matter of fact, unless two of the three partners die soon after the $150,000 insurance is taken out, the reimbursement of premiums largely wipes out this inequality.[1]

24. Should there be reimbursement of a defaulter for payments made? When?--If an associate defaults within three years after the agreement is drawn, the trust agreement should provide that he shall forfeit all payments which he has made. If the default occurs after three years,

1. "100 Questions and Answers" - #75, p.71,72

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25. What tax deductions are allowable for premium payments?--In general, business insurance premiums cannot be deducted from the Federal income tax returns of the individual associates or of the business organization as a whole, no matter whether the premiums are paid by the individuals or the firm.[1] This ruling is made because such payments do not represent a "business expense" but instead create a reserve for future use.[2]

There are, however, certain special cases in which premiums may be deducted. If a firm pays the premiums but receives its only direct or indirect benefit from the increased efficiency of the insured, it may deduct the premiums, but the insured must report them as taxable income.[3] If policies are assigned as collateral and the holder must pay the premiums, he can probably deduct those premiums.[3]

1. "100 Questions and Answers" - #31,32, p.34
2. I.T.B. #3 - p.3
3. Simon - p.279,281,282,283

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1. "100 Questions and Answers" - #31, 33, p.24
2. I.T.R. #3 - p.3
3. Simon - p.329, 381, 389, 389

A firm paying premiums on the life of a guarantor of a debt to the firm may deduct them. If a partner insures his life in favor of the second partner, at the latter's insistence, he may deduct the premiums unless the proceeds are to meet his own obligations or retire his business interest.[1]

C. CURRENT ADMINISTRATIVE PROBLEMS

26. What are the rights in loan and cash surrender values of the insured, the firm or corporation, and the trustee?--The business insurance trust agreement should determine whether or not the insured, the firm as such, and the trustee are to have the right to borrow money on any or all of the insurance policies. Probably the best plan would be to permit the insured and the firm to borrow on the policies only with the consent of all parties to the agreement. The trustee should be able to borrow on the policies to pay premiums, in case any of the parties should default.

If stock is pledged for an associate's personal benefit, then upon his death the trustee should pay the outstanding loans and obtain possession of the stock. The insurance proceeds payable to the decedent's estate will, of course, be decreased by the amount of such personal loans.[2] If the loan is for the corporation's benefit, the decedent's estate will receive the amount of money fixed by the trust agreement; but the company's cash available for paying this sum

1. Simon - p.282,283
2. "100 Questions and Answers" - #67,68, p.62

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1. Simon - p.888,889
2. "100 Questions and Answers" - #67,68, p.82

is decreased by the amount of the loan.[1] It is appropriate to note here that interest payments on policy loans are deductible on Federal income tax returns.[2]

The trust agreement should provide for the rights of the various parties if part or all of the insurance is turned in for its cash surrender value. This should be allowed only if all parties consent. No one individual should be allowed to cash in his insurance or withdraw from the trust at a mere whim.

27. Where is the voting control of the stock to be vested?--No matter whether the actual stock certificates are held by the stockholder, or endorsed in blank and deposited with the trustee, or held in the trustee's name on the corporation's books, the stockholder always keeps voting control of the stock. If the title to the stock has been transferred to the trustee, the trustee must either execute proxies in favor of the individual stockholders or ask their wishes in voting and vote the shares of each as each directs.[3]

28. Who holds the stock certificates?--In deciding whether or not the stock certificates of a close corporation should be deposited with the trustee, the wishes of the parties concerned should be followed,[4] and clearly set forth in the trust agreement. There are three methods by which stock

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1. "100 Questions and Answers" - #67,68, p.62
2. Simon - p.282,283
3. "100 Questions and Answers" - #22, p.26,27
4. I.T.B. #3 - p.7,8

is decreased by the amount of the loan. It is appropriate to note here that interest payments on policy loans are deductible on Federal income tax returns.

The trust agreement should provide for the rights of the various parties if part or all of the insurance is turned in for its cash surrender value. This should be allowed only if all parties consent. No one individual should be allowed to cash in his insurance or withdraw from the trust at a mere whim.

27. Where is the voting control of the stock to be vested?--No matter whether the actual stock certificates are held by the stockholder, or endorsed in blank and deposited with the trustee, or held in the trustee's name on the corporation's books, the stockholder always keeps voting control of the stock. If the title to the stock has been transferred to the trustee, the trustee must either execute proxies in favor of the individual stockholders or ask their wishes in voting and vote the shares of each as each directs.

28. Who holds the stock certificates?--In deciding whether or not the stock certificates of a close corporation should be deposited with the trustee, the wishes of the parties concerned should be followed, and clearly set forth in the trust agreement. There are three methods by which stock

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1. "100 Questions and Answers" - ¶27, 28, p.28
2. Simon - p.288, 292
3. "100 Questions and Answers" - ¶28, p.28, 29
4. I.T.S. ¶3 - p.7, 8

certificates in a close corporation may be held under a business insurance trust agreement.

Method A. Each stockholder keeps and controls his own stock certificates, but binds his executor or administrator to endorse them at his death and deliver them to the business insurance trustee for transfer at the agreed sale price.

Method B. Each stockholder deposits his stock, endorsed in blank or with a signed power of attorney attached, with the trustee at the time the trust agreement is made. The certificates remain in the stockholder's name on the corporation books.

Method C. Each stockholder transfers the title of all his shares to the trustee at the time the business insurance trust agreement is made; and the corporation thereupon issues new certificates in the trustee's name, which, however, show that they are held in trust under that specific trust agreement. In such a case "sufficient shares should remain in the individual names of the stockholders to qualify them as directors".[1]

There is no valid legal objection to Method A, although the deposit of stock with the trustee may prevent the interested parties and the representatives of the estate of a deceased stockholder from attempting to hinder the performance of the contract, and the trustee is thus placed in a stronger

1. "100 Questions and Answers" - #19, p.24

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Method C. Each stockholder transfers the title of all his shares to the trustee at the time the business insurance trust agreement is made; and the corporation thereupon issues new certificates in the trustee's name, which, however, show that they are held in trust under that specific trust agreement. In such a case "qualient shares should remain in the individual names of the stockholders to qualify them as directors".[1]

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1. "100 Questions and Answers" - #13, p.44

position for insisting upon a fair and impartial carrying out of the agreement. Moreover, if the stock is deposited in the first instance, the work of the probate court which has jurisdiction over the decedent's estate is simplified and more inevitably defined.

With regard to Method C there are three main advantages and four disadvantages, some of which will be considered again under other questions. The advantages are that title to the stock is definitely vested in the trustee; the trustee can carry out the agreement without any active help from the executor or administrator of the deceased's estate; and the executor or administrator can report to the probate court that because the decedent gave up during his lifetime the title to his stock, the only thing remaining for the executor or administrator to do was to receive the consideration. The disadvantages of this plan are that: the trustee must receive dividends and send them to the stockholders in proportion to the number of shares turned in; the trustee must execute proxies in favor of the depositing stockholders, or vote the stock as they direct; every change in the corporate structure must be made through the trustee (which is a great nuisance); and some stockholders will not favor a plan requiring them to part with the title to their stock - indeed, they often hesitate even to part with the certificates endorsed in blank (Method B).[1]

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1. "100 Questions and Answers" - #22, p.26,27

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1. "100 Questions and Answers" - ISS, p.35,39

One authority says that if Method B is adopted, with the title remaining in the stockholder, the corporation whose stock is involved may insist as a precautionary measure that the executor or administrator of the decedent's estate join in the transfer. It is believed, however, that such additional assignments are unnecessary. This Method B is the one generally followed.[1] The agreement should provide that at any time during its life the certificates may be withdrawn by the mutual consent of all parties.[2]

29. Who is to receive dividends, including extraordinary or stock dividends?--No matter who holds the stock certificates, the true "stockholders" in the broad sense of the word must ultimately receive the dividends. If the "stockholder" actually holds and controls his stock, or if he deposits it with the trustee, endorsed in blank, he is listed as the owner on the corporation books and therefore receives all dividends directly.[3] If he has transferred the title to his stock to the trustee as trustee under the agreement, so that the stock is listed in that way on the corporation books, the trustee receives all dividends and must immediately pay them out to the individual "stockholder" in proportion to the number of shares which he has turned in.[4]

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1. "100 Questions and Answers" - #21, p.25,26
2. "The Boston Anchor" - June, 1930 - George E. Coates: "Functions of Business Life Insurance"
3. "100 Questions and Answers" - #19, p.24
4. "100 Questions and Answers" - #22, p.26,27

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1. "100 Questions and Answers" - #31, p.29, 30
2. "The Boston Anchor" - June, 1930 - George E. Cortes: "Functions of Business Life Insurance"
3. "100 Questions and Answers" - #16, p.84
4. "100 Questions and Answers" - #28, p.26, 27

30. How long is the agreement to run? Should an extension be permitted?--The business insurance trust agreement may run for any length of time up to the legal limit set by the "Rule Against Perpetuities". The old common law rule, which most states still follow, "renders void all interests which by any possibility may not vest within lives in being and 21 years thereafter".[1] A Massachusetts case mentions that "a common form of the statement of the rule against perpetuities is that executory limitations or interests are void unless they take effect ex necessitate and in all possible contingencies within a period not exceeding 21 years after the termination of a life or lives in being at the creation of them."[2]

Although most states keep the common law rule against perpetuities, New York has arbitrarily changed the time to two lives in being. This time may be figured in two ways.

a. The agreement may be drawn so as to end at the death of the second of two specified individuals. There is, however, an implied understanding that when that time comes, the surviving associates will make a new agreement during the lives of two other designated parties to that agreement, etc.

b. The agreement may end upon the death of whichever party to the agreement is the second to die. There is

1. New England Trust Company - "The Management of Trust Property"
2. Rugg, Eastman Marble Co. vs. Vt. Marble Co., 236 Mass. 138

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31. Should the agreement be revocable? Under what conditions?--"Experience has proven the desirability of creating the trust in such a form that it may be amended or even terminated as future conditions may require or the judgment of the trustors may dictate."[1] Yet the agreement should not be so loosely drawn that one associate may set it aside at a mere whim. Perhaps the best plan is to provide for revocation by mutual consent of all parties.[2]

32. Should the stock be withdrawable from the trustee? For what purposes?--A stockholder should be able to withdraw his stock from the trustee, if all the other parties to the agreement consent, for the purpose of pledging his stock as collateral for a personal loan. No one stockholder should have the uncontrolled right to withdraw his own stock from the trustee, because this would permit one participant to nullify the trust agreement. If the corporation carries the insurance and pays the premiums, the board of directors should make the decision in each case as to whether the stockholder should be allowed to withdraw the stock.[3] If each stockholder carries the insurance on the lives of the others, then all should consent before any one is allowed to withdraw his stock.[3]

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1. "100 Questions and Answers" - #56, p.52,53
2. "100 Questions and Answers" - #76, p.72
3. "100 Questions and Answers" - #66,67,68, p.61-63

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1. "100 Questions and Answers" - ¶96, p. 88, 93
2. "100 Questions and Answers" - ¶78, p. 73
3. "100 Questions and Answers" - ¶96, 97, 88, p. 81-83

Stock should not be permitted to be withdrawn from the trustee for any other purpose than to serve as collateral for a personal loan.[1]

One authority advises that each stockholder should have the right to withdraw from the organization and from the agreement, but that the retiring participant should be forced to offer his stock first to the remaining associates sharing in the agreement. If these, however, do not exercise their option to purchase the stock within a given period, the stockholder should be allowed to sell it to an outsider.[2]

33. What are the rights of the parties if a partially-performed agreement cannot be completed?--The agreement cannot be revoked or emended without the consent of all the parties to it.[2] The terms of the agreement should not permit a party owning a large majority interest to withdraw, although one who has limited means and a small interest should be treated more liberally.

The agreement may provide that if a party withdraws at some future time, he has the right to purchase his own policy for its cash value at that time. The one who withdraws pays the cash value of the policy to the business organization, and in return receives the policy.[2]

34. What arrangement should be made for the admission of new parties previously either unwilling or without an insurable interest?--If upon drawing up a business insurance trust

1. "100 Questions and Answers" - #66,67,68, p.61-63
2. Simon - p.86,87,178

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34. What arrangement should be made for the suspension of some partner personally either qualifying or without an insurable interest?--If upon drawing up a business insurance agreement

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1. "100 Questions and Answers" - Mss, 87, 88, p. 81-82
2. Simon - p. 88, 87, 178

agreement some members of the business organization do not wish to participate, it might be well to construct the agreement so that they can come in at some future time by the payment of back premiums or by taking their proper share of the cost of additional insurance. It might also be well to provide in the agreement for the similar entry of any new party who, having previously lacked an insurable interest, has now become possessed of one.

35. What disposal is to be made of the policies in case of the dissolution of the business?--If the business organization has carried the insurance, the policies, at the dissolution of the business, are to be transferred to the organization by change of beneficiary or by assignment according to the agreement. Thus the policies become part of the concern's assets and are to be treated as such in the dissolution of the business. One authority suggests that in this case each associate shall have the option to repurchase the policies on his own life. Thus each individual member can purchase his own policy, taken out at a younger age and at a lower premium rate, by paying the cash value or, if preferred, the total net premiums to the business organization.[1]

If each member of the organization has paid his proportionate share of the premiums on the lives of the other members, the policies at the dissolution of the business will be transferred to the individual associates by change of

1. Simon - p.86,87,178

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1. Simon - p.88, Ch. 178

beneficiary or assignment, according as the ones who have paid the premiums shall determine.[1]

D. BENEFICIARY AND FINAL SETTLEMENT

36. Who is to be the beneficiary?--Authorities differ in choosing the best immediate beneficiary to name in the various insurance policies. The greatest weight of opinion, however, seems to favor the business insurance trustee rather than the firm or the surviving associates. The trustee is thus used as an intermediary in receiving the policy proceeds from the insurance company and in paying to the decedent's estate, which is the ultimate beneficiary, the agreed value of his business interest in return for his stock or, if a partnership, the relinquishment of all claim to his share in the business. Moreover, for technical reasons which will be dealt with under Problem 45 of this section, the use of a trustee as immediate beneficiary may greatly lessen the taxes for which the firm or its surviving members might otherwise be liable.

In planning the agreement, each associate should decide whether he wishes the proceeds of his business interest ultimately paid to his family, to his estate as such, or directly into a personal insurance trust which he may have or may establish at the same time.

Some authorities consider that a personal insurance trust supplemental to a business insurance trust is unde-

1. "100 Questions and Answers" - #78, p.73

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1. "100 Questions and Answers" - #18, p.73

sirable. "The trust if created would cover the proceeds of sale of stock belonging to the deceased, and to be valid the stock itself must be transferred to the trustee in the deceased's lifetime; otherwise it is nothing more than a transfer after death, which must be by will. The trustee must become the real owner of the stock at the time the trust agreement is entered into and must continue to act as such."[1]

37. Shall the right be reserved to change the beneficiary?--The trust agreement should certainly reserve the right to change the beneficiary upon the consent of all other parties to the agreement. This qualifying clause will keep the agreement sufficiently flexible to meet changing conditions, while it obviates the danger of frequent changes of beneficiary to suit the whims of certain associates.

38. What causes shall terminate the trust?--The five chief causes for the termination of a business insurance trust are:[2]

"(1) Mutual consent;

(2) The lapse of all the insurance policies without value;

(3) The dissolution, bankruptcy, or insolvency of the firm or corporation;

(4) The simultaneous deaths of all the stockholders or partners;

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1. I.T.B. #3 - p.8
2. "100 Questions and Answers" - #76,77, p.72,73

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38. What causes shall terminate the trust?--The five other causes for the termination of a business insurance trust are:[2]

"(1) Mutual consent;

(2) The lapse of all the insurance policies without value;

(3) The dissolution, bankruptcy, or insolvency of the firm or corporation;

(4) The simultaneous deaths of all the stockholders or partners;

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1. I.I.S. #3 - p.9

2. "100 Questions and Answers" - #78,77, p.78,79

"(5) The completion of the duties of the trustee after the death of any partner or stockholder, or after the death of the next to the last survivor of all the partners or stockholders, depending on whether the agreement contemplates its continuance beyond the death of the first one of the parties to die."[1] Such a provision depends on the wishes of the parties.

39. What arrangement shall be made for retirement of the decedent's interest?--In the first place, it should be kept in mind that where the trust agreement provides for the payment of the insurance to a trustee for subsequent transfer either to the decedent's estate or to a named beneficiary, this arrangement serves as legal "consideration" for the retirement of the decedent's business interest. Hence the trust agreement legally binds the decedent's estate to assign and transfer his business interest to his surviving associates.[2] "The agreement should be made binding on the parties, their heirs, executors, administrators, and successors."[3]

One highly important point to remember is that it is unwise to provide in the business insurance trust agreement that the purchase price of the decedent's interest shall be the actual proceeds of the business insurance policies on his life. "Suppose half of the insurance on the decedent's life were to lapse by mistake or neglect of some employee

1. "100 Questions and Answers" - #76,77, p.72,73
2. "The Boston Anchor" - June, 1930 - George E. Coates: "Functions of Business Life Insurance"
3. "100 Questions and Answers" - #59, p.54

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1. "100 Questions and Answers" - NYC, NY, p.73,73
3. "The Boston Anchor" - June, 1930 - George E. Coates: "Questions of Business Life Insurance"
3. "100 Questions and Answers" - NYC, p.84

just before a party's death; is his estate to receive only half the value of his business interest?"[1]

Further phases of the retirement of the decedent's interest will be considered under Problems 40-44 of this section.

40. What plan should be made for payment of any balance due?--If the insurance proceeds exceed the value of the decedent's interest, the excess must be paid as the agreement directs; and if the proceeds are less than the value of this interest, the surviving associates must make up the deficiency, usually by notes payable in installments. The agreement may also require the reimbursement of the decedent's estate for premiums which the deceased has paid on the surviving associates' lives, or the payment to the decedent's estate of the cash value of the decedent's interest in such policies.[2] Thus if the insurance proceeds on the decedent's life are barely sufficient to purchase his business interest, the surviving associates may have to pay a considerable sum to acquire his interest in their policies. No adequate discussion of this problem by any authority has been found by the writer. Apparently at the time of drawing up the trust agreement the associates must decide whether to carry a surplus of insurance sufficient to meet such an extra claim, or whether to assume that the surviving associates can always meet it by cash or notes.

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1. "100 Questions and Answers" - #45, p.43,44
2. Pro. 12th - 1931 - p.100

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1. "100 Questions and Answers" - Ass'n, p. 43.
2. Pro. 13th - 1931 - p. 100

If the insurance proceeds are less than the value of the decedent's business interest and if the surviving associates give notes for the balance, the business insurance trustee should take an active interest in the business in order to guard against milking of the assets by these surviving associates "to the point where there will be no inducement to pay" for the remaining portion of the decedent's interest, which the trustee is still holding in trust until the notes are paid.[1]

It has been suggested, moreover, that notes for the balance of a decedent's interest should not run for longer than three years; and it has also been suggested that the prospective trustee should insist upon the insertion of this provision in the trust agreement, even refusing to take the trust otherwise (unless the parties take out enough additional insurance to cover any such balance).[1] Such extreme measures seem highly absurd. Why should the trustee have the right to decide at the time the trust agreement is drawn how long the surviving associates in any business should reasonably take to pay off their notes after each associate dies? The situation may arise twenty years later, under utterly changed circumstances. To illustrate from current conditions, if the first associate died in 1929, the balance might have seemed easily payable in three years, yet by 1932 the surviving associates might have succeeded in paying less than

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1. "100 Questions and Answers" - #71, p.66

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1. "100 Questions and Answers" - #41, p.98

half. How would a three-year limit on the notes help in that case, unless the trustee wished to force the concern into bankruptcy - the very misfortune which the trust agreement was planned to prevent? Surely it would be far better to make the time limit on the notes depend on business conditions at the time the notes are made, and to permit extension of that limit if business conditions change so decidedly as to make it absolutely necessary.

41. What disposal shall be made of any excess insurance?-- The contracting parties often wish to provide in the trust agreement that "the price paid for the decedent's business interest shall in no event be less than the proceeds of the insurance policies on his life. Such a provision acts as a guarantee to each party and as a mutual protection to all the parties."[1] If this provision is not desired, any excess of insurance proceeds over the decedent's business interest should logically belong to whoever paid the insurance premiums. However, the parties may decide for personal or sentimental reasons to pay such excess to the decedent's estate, to his widow, or to any other beneficiary named by him. "This question becomes particularly important if the policies on the lives of the parties contain double indemnity or accident features which may greatly increase the proceeds which will be collected by the trustee upon the death of any party.[1] The solution to this question rests entirely upon

1. "100 Questions and Answers" - #53,54,p.50,51

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1. "100 Questions and Answers" - #33, 34, p. 30, 31

the wishes of the parties."[1] So far as is possible, the disposition of such excess should be covered by the trust agreement.

42. Who is to become the owner of the decedent's interest?—The business organization itself or, if preferred, the surviving associates purchase the decedent's interest with the help of the business insurance which has been carried on his life. As we have seen, the business insurance trustee pays the insurance proceeds to the decedent's estate in return for an assignment of the decedent's business interest, or if a corporation, in return for his stock. The trustee then delivers the assignment or the stock to the surviving associates.

With regard to a corporation's right to buy its own stock, the law says: "In the absence of constitutional, statutory, or charter restrictions, by the weight of authority in the United States, a corporation may purchase and hold shares of its own stock, provided that the corporation in making such purchase is acting in good faith and that the consideration paid is not unequal or disproportionate to the value of the stock, that the corporation is solvent and not contemplating or in process of dissolution and that the rights of creditors and non-assenting stockholders are not adversely affected."[2] The great majority of the states fol-

1. "100 Questions and Answers" - #53,54, p.50,51
2. Corpus Juris - Vol. 14A, p.275

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1. "100 Questions and Answers" - 1953, p. 84, p. 30, 31
3. Corpus Juris - Vol. 14A, p. 875

low this rule. In four states, however - California, Kentucky, Vermont, and Wyoming - corporations are forbidden by statute to purchase their own stock. In four other states - Kansas, Louisiana, Alabama, and Tennessee - there are court decisions to the same effect. Thus in any of these eight states the stockholders as individuals would have to carry the insurance.[1]

43. In what shares or proportions shall the stock pass to the parties in interest?--The proportions in which the stock goes to the parties in interest must be carefully worked out in the trust agreement. There may be some particular reason why the stock should not be divided among the surviving associates in the proportion which their respective holdings in the business bear to each other. For instance, the head of a business, who is the majority stockholder, may want his son, who now has only a very small stock interest, to inherit all or the greater part of the father's stock if the son so desires.

Probably in most cases it is best to provide in the trust agreement for the proportional distribution of the decedent's stock to the surviving associates in accordance with the amount of insurance which each carried on the decedent's life, or if the corporation carried the insurance, in accordance with the interest of each in the corporation.[2]

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1. I.T.B. #3 - p.6
2. Simon - p.120,124

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1. I.T.R. #3 - p.8
2. Simon - p.150, 184

Thus the balance of ownership remains the same among the surviving associates.[1]

Another plan which the associates might favor would be for the trustee to pay all the decedent's shares into the corporation treasury to be held as treasury stock. This treasury stock could then be reissued to anyone at any time at any suitable price; and it would be immediately available if the company wished to admit a new member - thus avoiding arguments as to where new stock would come from for this purpose. No dividends would be paid on such treasury stock, and it would not destroy the status quo of the proportions of the surviving associates' interests.

44. Should partnership real estate be conveyed by a separate deed?--In the conveyance of partnership real estate to the surviving partners, the business insurance trust agreement should be supplemented by a separate deed to the real estate. One plan is to have each partner and his wife execute a deed to the other partners according to their proportionate interests in the firm. All the deeds are held in escrow by the trustee, unrecorded, until one partner dies. The trustee then delivers the appropriate deed to the surviving partners in return for the purchase price of the decedent's interest, which the trustee pays to the decedent's estate or to his beneficiaries.[2]

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1. Simon - p.120,124
2. "100 Questions and Answers" - #55, p.51,52

Another plan, for use in states permitting joint tenancy with the right of survivorship, is to have the partners and their wives deed the real estate to a third party (to eliminate dower rights) and to have the third person deed the real estate to the partners as joint tenants with right of survivorship.[1]

Another highly recommended plan is "to have the wife of each partner join in the business insurance trust agreement, or sign a separate consent or release attached as an exhibit to the agreement. This should be done as a precautionary measure so that it would act as an equitable estoppel should any question arise."[1]

45. What tax liability as regards principal is involved or avoided?--Life insurance proceeds paid as death claims are not subject to either State or Federal income tax, whether paid in a single sum or in installments, although if the insurance company keeps the proceeds and pays the beneficiary the interest, that interest is subject to income tax when received. Insurance policies cashed in for a profit over net cost, and matured endowment policies and annuity payments where the total received exceeds the net cost are subject to income tax on such excess.[2] There is only one exception to the rule that life insurance proceeds collected upon the death of the insured are not subject to income tax as income

1. "100 Questions and Answers" - #55, p.51,52
2. Simon - p.279

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1. "100 Questions and Answers" - CPA, p. 81, 82
2. Simon - p. 279

or profits, no matter who carries the insurance. The exception provides that "where insurance policies are transferred for a valuable consideration, then the total amount received, less the total of this consideration plus premiums subsequently paid, must be included as taxable income. A case where this exception might possibly apply would be where the insurance used in connection with the insurance trust had been carried for some time by the stockholders, and as a part of the transaction the corporation for a valuable consideration purchased the existing insurance from its stockholders."[1]

Life insurance involved in a business insurance trust is not subject to state inheritance taxes, but the value of the decedent's interest in the business at his death will be taxed.[2] Moreover, "if life insurance is payable to a corporation, it increases the value of the stock for inheritance tax purposes."[3] Therefore if business interests of an associate are to be retired at his death, the insurance proceeds should be payable to the surviving associates or to a corporate trustee, not to the corporation.[3]

As an example of enhancement of value for state inheritance taxes, let us suppose that A, B, and C share equally in a $150,000 corporation, which carries $150,000 insurance on the life of A (the president) payable to the corporation.[4]

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1. "100 Questions and Answers" - #33, p.34,35
2. "100 Questions and Answers" - #35, p.36
3. Simon - p.285
4. Simon - p.283

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1. "100 Questions and Answers" - ¶33, p.34, 35
2. "100 Questions and Answers" - ¶33, p.38
3. Simon - p.383
4. Simon - p.383

Upon A's death, therefore, the corporation is worth $300,000, and A's one-third stock interest is valued at $100,000 for inheritance tax purposes.[1] If the insurance had been payable to the surviving associates or to a corporate trustee, A's stock would have been taxed on the original $50,000 basis.

This rule regarding state inheritance taxes "necessarily affects the beneficiaries under a decedent's stock ownership to the extent of such appreciation of corporate assets. When part of the premiums are paid by the insured and part by other than the insured, then that percentage which premiums so paid by the insured bears to the total premiums paid becomes taxable; but where premiums are paid by individuals having insurable interests, the proceeds are not taxable. Where an insurance trust is funded by the insured and all rights of revocation or income from such fund are retained, then there is no escape from taxation; but where the trust is funded by the wife of the insured and the rights to revoke are vested in other than the insured, there are no inheritance taxes."[2]

One authority believes that in most states the proceeds of the sale of the decedent's business interest to the surviving associates would probably be subject to state inheritance tax, "because in practically every business insurance trust the contracting parties retain the beneficial enjoy-

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1. Simon - p.283
2. Manning Manse - 1939 - p.10

Upon A's death, therefore, the corporation is worth $800,000, and A's one-third stock interest is valued at $100,000 for inheritance tax purposes. [1] If the insurance had been payable to the surviving associates or to a corporate trustee, A's stock would have been taxed on the original $30,000 basis.

This rule regarding state inheritance taxes "necessarily affects the beneficiaries under a decedent's stock ownership to the extent of such appreciation of corporate assets. When part of the premiums are paid by the insured and part by other than the insured, then that percentage which premiums so paid by the insured bears to the total premiums paid becomes taxable; but where premiums are paid by individuals having insurable interests, the proceeds are not taxable. Where an insurance trust is funded by the insured and all rights of revocation or income from such fund are retained, then there is no escape from taxation; but where the trust is funded by the wife of the insured and the rights to revoke are vested in other than the insured, there are no inheritance taxes." [2]

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1. Simon - p.283
2. Mowatt Memos - 1939 - p.10

ment of their stock or partnership interest during their respective lives."[1]

In Massachusetts we have no particular trouble about state taxation of insurance, because the state has been very liberal. It has made the proceeds of insurance policies exempt from taxation unless they are payable to the decedent's estate.[2]

With regard to Federal estate taxation, it should be remembered that insurance carried by the deceased in excess of $40,000 is subject to estate tax, no matter to whom it is payable.[3]

The Federal estate tax applies only to such business insurance as is taken out and paid for by the insured, because it applies to the proceeds of life insurance policies only if taken out by the decedent on his own life. "If the policy is taken out and carried by a corporation, or a fellow partner or stockholder, the estate tax would not apply, even though the proceeds are to be used to purchase the interest of the insured in the corporation or partnership. If the purchase price comes into the estate of the insured it will be subject to tax but not as insurance.[4] If a partnership carries the insurance, then the Federal estate tax would probably apply to the extent of the proportionate interest

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1. "100 Questions and Answers" - #30, p.33
2. Manning Manse - 1929 - p.10
3. I.T.B. #3 - p.3
4. "100 Questions and Answers" - #36, p.36

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1. "100 Questions and Answers" - #30, p.35
2. Manning Manze - 1933 - p.10
3. I.T.R. #3 - p.3
4. "100 Questions and Answers" - #36, p.38

of the deceased in the partnership, because to that extent he is carrying his own insurance."[1]

One authority urges that each stockholder in a close corporation business insurance trust should insure the lives of the others, because in a few states corporations cannot buy their own stock, and also because life insurance with premiums paid by other than the insured would be exempt from tax at the insured's death. In addition, if the insurance proceeds exceeded the amount used in purchasing the stock, the excess might be disbursed "in the form of a dividend which in the hands of the recipient would be subject to surtax."[2]

46. Should there be a bond to protect a decedent's estate from further liabilities?--In a partnership business insurance trust agreement "the survivors should be required to deliver to the decedent's executor a bond as protection against the debts of the partnership as of the date of the decedent's death. This will protect the decedent's estate against any possible action of any creditor of the partnership under the legal liability of any partner for the debts of the partnership."[3]

It would be well to make the same provision in a corporation trust agreement in the case of any insured who regularly endorses corporation paper in the course of business.

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1. "100 Questions and Answers" - #36, p.36
2. I.T.B. #3 - p.15
3. I.T.B. #3 - p.19

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1. "100 Questions and Answers" - W&P, p.88
2. I.T.B. #3 - p.15
3. I.T.B. #3 - p.15

This would eliminate the danger of suit by creditors on some routine endorsement.

47. What are the rights of creditors?--In a partnership business insurance trust, if the partnership carries the insurance, pays the premiums, and is the beneficiary of the policy under an express agreement that the proceeds will be used to purchase or retire the deceased partner's interest, "the partnership creditors could frustrate the arrangement and reach the proceeds of the policies".[1] The creditors could probably still reach the insurance proceeds if the partnership carried the insurance and paid the premiums, with the proceeds payable to a trustee under an express agreement to turn them over to the decedent's estate upon assignment and transfer of the decedent's interest to the surviving associates. In this latter case creditors could reach the proceeds "on the ground that the assets of the partnership had been used to carry the insurance, thus depleting the amount available for creditors, and that the partnership assets cannot thus be diverted from the reach of its creditors".[1] Moreover, because the partnership debts are debts of each partner, the creditors could thus reach the policy proceeds to satisfy them. In addition the decedent's business interest, which would pass to the surviving partners, would also be subject to the firm's debts.[1]

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1. "100 Questions and Answers" - #41, p.40

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1. "100 Questions and Answers" - Weil, p.90.

tionate share of the insurance on the lives of his co-partners, so that each partner individually - not the partnership - carries the insurance and pays the premiums. Under this arrangement the partnership is not a party to the agreement. Inasmuch as the creditors of the partnership are still creditors of the individual partners, they might still reach the proceeds of the insurance policies, but the liability of the individual partners or the estate of the deceased partner for partnership debts is secondary to the liability of the partnership itself."[1]

In a corporation business insurance trust, as concerns the rights of creditors to claim the business insurance proceeds of an insolvent corporation, there is a difference of opinion if the corporation itself has paid the premiums on the lives of its stockholders and if the proceeds are payable under a business insurance trust agreement directly to the corporation or to a corporate trustee, to be used in either case to purchase and retire the decedent's stock. Assuming that the corporation is insolvent only when the proceeds are paid, "the best authority seems to be that the corporation's creditors could force the diversion of the insurance proceeds from the purchase and retirement of the decedent's stock."[2] On the other hand, a very strong argument could be made that if the corporation were solvent when the insurance was taken

1. "100 Questions and Answers" - #41, p.40
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1. "100 Questions and Answers" - #41, p.40
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out and when the collateral written agreement or the business insurance trust was prepared and executed, and if the insurance premiums had been largely paid out of earnings without depleting the capital of the corporation, then the trust would stand regardless of the attacks of creditors."[1]

In general if shock absorption insurance (such as insurance to absorb the shock of the death of the "managing brains of the business") is made payable to a trustee instead of directly to the business, creditors cannot appear inopportunely to claim it, and cannot by thus reducing the working assets available for the new manager, at a time when, on account of the changed conditions, they are narrowing the credit they extend to the organization, make the business unable to meet its obligations and thus endanger it.[2]

IX. The Essential Elements of a Sound Business Insurance Trust Agreement Summarized.--From the maze of these nearly fifty problems through which the intelligent underwriter, the associates who desire to create a trust, and the trustee who will have the keeping of the trust have been compelled to wander before they could even begin to draw up their agreement, they emerge at last with a fairly clear idea of certain provisions which that agreement must contain if it is to be both sound and adequate. Eleven points stand out with espe-

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1. "100 Questions and Answers" - #60, p. 28
2. Boston Life Insurance Trust Council Notes

cial distinctness as self-evidently common to every good business trust agreement.[1] It must provide:

1. A competent and impartial trustee (if possible a corporate fiduciary).

2. A clearly-defined method of financing through life insurance policies payable to the trustee the purchase of a decedent associate's interest.

3. A clearly-defined arrangement whereby the evidence of property shall be held by the trustee.

4. A clearly-defined method of valuing the business' net worth.

5. A plan for due reimbursement for insurance premiums.

6. Adequate provision for borrowing on the stock and on the cash value of the policies.

7. A clearly-defined method of procedure in case the amount of insurance does not equal the value of the decedent's interest.

8. A clearly-defined method of procedure in case the amount of insurance exceeds the value of the decedent's interest.

9. Due provision for any necessary amendment of the agreement.

10. A clearly-defined method of procedure for terminating the agreement under every probable contingency.

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1. I.T.B. #3 - p.10

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1. I.T.B. #3 - p.10

duties, and compensation, including revocation charges.[1]

X. Methods of Utilizing Business Insurance Trusts for Certain Definite Purposes.--Let us now take the further step of stating the exact methods whereby each type of business organization may draw up such an agreement as will contain the foregoing eleven essential elements and employ them with other elements to attain some definite result desired. To avoid needless repetition here, only such of the essential elements will be mentioned in each case as have a direct bearing upon the particular problem involved.

Method A. For Sole Proprietorship.--"The business insurance trust agreement should provide for the incorporation of the business after the owner's death - all stock to be issued to the decedent's estate in return for the assets and Goodwill of the business; should provide for a corporate trustee to hold the proceeds of the insurance until the incorporation has been completed; should name the employees who are to benefit from the arrangement, and in what proportions; should specify the price at which stock is to be delivered to them, or a method of determining the price; and should obligate the decedent's employees to give their best services and talents to the welfare of the corporation.[2] In most cases it will be well to keep control of the corporation in the decedent's estate until his employees, who become stockholders after his death, are ready to take over for value all, or substantially

1. I.T.B. #3 - p.10
2. "100 Questions and Answers" - #5, p.8,9

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1. I.T.S. #3 - p.10
2. "100 Questions and Answers" - #3, p.8#8

all, of the estate's remaining stock."[1]

In addition to these provisions it is well for the decedent's own will to direct the decedent's executor or trustee to incorporate the business and authorize its continuance, although the will need not refer to the business insurance trust agreement. Neither the will nor the trust agreement need contain any details about management; and although the testator may leave a memorandum suggesting how he wishes the business handled, he should not make his directions mandatory, for fear of harming the business as conditions change.[1]

Method B. For Partnership.--The business insurance trust agreement should provide for the payment of the partnership insurance either to the purchasing partners (with each taking out enough insurance on each other member's life to pay for his desired proportion of that other partner's interest upon that other partner's death, and with each partner paying the premiums, being named as beneficiary in the policies, and having entire ownership of the policies), or to the partnership itself (with the proceeds to be used to purchase and retire the deceased associate's interest, thus proportionately increasing the surviving associates' interests), or to the trustee (with the proceeds to be transferred to the deceased partner's estate or to a named beneficiary in payment of the decedent's partnership interest, which the decedent's estate

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1. "100 Questions and Answers" - #5, p.8,9

is legally bound by the agreement to transfer to the surviving partners). The agreement should also provide for delivery by the trustee to the surviving associates of a receipt and release of claim to the partnership assets from the deceased partner's executor (whereupon the decedent's interest passes to the surviving associates in the proportions named in the trust agreement); should require the surviving partners to give the decedent's executor a bond protecting the estate against possible suits by partnership creditors; and should provide for disposal of the insurance policies on the lives of the surviving partners.

Method C. For Close Corporation.--The business insurance trust agreement should provide for the payment of the close corporation business insurance to the purchasing stockholders, to the corporation (but only in those states permitting the corporation to purchase its own stock), or to the trustee, all under restrictions similar to those outlined above under Partnership.

Method D. To Compensate for Loss of Services of Valuable Officer or Employee.--The business insurance trust agreement should provide for payment of insurance of this type to the business organization as such, instead of to individuals; should not allow the insured to reserve the right to change the beneficiary of the policy; should provide for payment of premiums by the business; and should entitle the business or-

ganization to all rights granted the insured under the insurance policy (including policy dividends, and the right to use the cash values and loan values); or should, if preferred, provide for writing the policy payable to the insured's estate and assigning it absolutely to the business organization.

Method E. For Credit Purposes.--The business insurance trust agreement should provide for insurance on the lives of the leading executives for the purpose of maintaining the credit of the business organization, to be written payable to that organization; should not reserve to the insured the right to change the beneficiary; and should provide that the business organization shall pay the premiums and be entitled to policy dividends, cash values, loan values, and all other privileges and benefits granted to the insured under the policy. The agreement may also provide for writing the policy payable to the insured's estate and assigning it absolutely to the business organization; and in any case it should provide for assignment of the policy as collateral security either to a creditor of the business organization or to a trustee for the creditors.

Method F. In Lieu of Sinking Fund.--The business insurance trust agreement should provide that if one of the responsible officers of the business dies while any bonds or preferred stock remain outstanding, the trustee is to use the insurance proceeds to retire that amount of bonds or pre-

ferred stock, using, if advisable, endowment insurance for this purpose, with the insurance assigned or made payable directly to the trustee for the bondholders.

Method G. To Retire a Living Associate's Interest.--The business insurance trust agreement should provide that if the respective associates in the business organization are still alive at certain specified ages, the cash surrender values of their business insurance can be used as a partial payment for retiring them from business.

Method H. As an Emergency Fund.--The business insurance trust agreement should provide that the cash surrender values of the policies may be used as an emergency fund in the business while all the associates in the business organization are alive, if the business needs more money than the associates can borrow elsewhere.

XI. Important Legal Aspects Summarized.--In dealing with so involved a subject as business life insurance, it is well to remember that practically every problem raisable is potentially a legal problem, because practically every point at issue, if unwisely handled, may become the basis for a legal suit. Certain problems, however, have already taken on definite legal characteristics and have been the subject of court decisions. Stated briefly for the sake of summarization, the most important of these problems are:

1. A statement of the various forms of business organ-

izations (Section III);

2. The liability of key men for the endorsement of corporation paper (Problem 2);

3. The question whether business insurance should be included in the organization's financial statement (Problem 5);

4. An authorization of the business insurance trust procedure by the stockholders (Problem 11);

5. The questions regarding an insurable interest (Problem 12);

6. The continuance of an insurable interest (Problem 13);

7. The question of assignment vs. a change of beneficiary (Problem 14);

8. Avoidance of conflict with other documents (Problem 15);

9. Creditors' rights (Problems 16 and 47);

10. A corporation's right to carry insurance on the lives of its stockholders (Problem 16);

11. The question of who shall hold the stock certificates (Problem 28);

12. The "Rule against Perpetuities" (Problem 30);

13. The retirement of the decedent's interest (Problem 39);

14. A corporation's right to buy its own stock (Problem 42).

XII. Tax Problems Summarized.--Like the legal problems, the problems of taxation underlie an amazing number of the

points for consideration in dealing with business insurance trusts. The variation of a few words in the agreement, or a slight change in the source of payment of the premiums may make a tremendous change in the tax liability involved. Because of the incessant alterations in tax rulings and tax interpretation, it is not feasible in such a study as the present to go far into detail in tax matters. The following points, however, have been briefly considered in the foregoing pages:

1. The valuation of the business from the taxation viewpoint (Problem 3);

2. The use of old policies (Problem 9);

3. The tax liability if the partnership or corporation per se pays the premiums (Problem 16);

4. Tax deductions for premiums (Problem 25);

5. Tax deductions for interest payments on policy loans (Problem 26);

6. The selection of the beneficiary from a taxation viewpoint (Problem 36);

7. The tax liability of business insurance proceeds (Problem 45).

XIII. Essential Qualifications of Business Insurance Trustee.--We have already seen that the creation of business insurance trusts is a highly technical field requiring the services of competent and kindly life underwriters and trust

points for consideration in dealing with business insurance trusts. The variation of a few words in the agreement, or a slight change in the source of payment of the premiums may make a tremendous change in the tax liability involved. Because of the incessant alterations in tax rulings and tax interpretation, it is not feasible in such a study as the present to go far into detail in tax matters. The following points, however, have been briefly considered in the foregoing pages:

1. The valuation of the business from the taxation viewpoint (Problem 3);

2. The use of old policies (Problem 9);

3. The tax liability if the partnership or corporation per se pays the premiums (Problem 15);

4. Tax deductions for premiums (Problem 35);

5. Tax deductions for interest payments on policy loans (Problem 35);

6. The selection of the beneficiary from a taxation viewpoint (Problem 38);

7. The tax liability of business insurance proceeds (Problem 45).

XIII. Essential Qualifications of Business Insurance Trustee.--We have already seen that the creation of business insurance trusts is a highly technical field requiring the services of competent and kindly life underwriters and trust

officers, but their creation is merely the first step to ensure their being adequately carried out. The duty of carrying out the trusts rests entirely on the trustee's shoulders. It is not enough to say vaguely that a business insurance trustee must be "capable". The trustee must be absolutely accurate in all matters; must use care and genuine tact to avoid the appearance of officious meddling in the affairs of the business enterprise (while yet helping to run it if the trust agreement so directs); must keep all secrets of the business strictly inviolate; must act with impartial fairness toward all concerned; and must show absolute reliability and thoroughness in recording all transactions coming under the trust.

XIV. Functions of Business Insurance Trustee.--During the lifetime of the creators of the trust, the business insurance trustee has various highly important functions: he holds the insurance policies until they mature and sees that the premiums are paid promptly; in the case of a close corporation, he often holds in escrow the stock of the various associates pending the redistribution of each member's shares at death; or, if preferred, he holds in his own name the stock of the corporation, receiving and transferring dividends to the actual owners of the stock, sending them proxies for voting, or voting the stock as they direct.

At the death of one of the associates, as we have seen,

the business insurance trustee collects the proceeds of the insurance and turns them over to the decedent's estate or heirs, and delivers to the surviving associates the estate's or heirs' receipt and release of claim to the decedent's interest in the business.[1] He also oversees the maintenance of the property[2] while it is in his charge pending settlement, keeps accurate books and makes periodic reports, makes (if the trust agreement so directs) a valuation and appraisal of the business, distributes such income and principal as he receives while the property is in his charge, and receives compensation.[3] In all these functions he is bound by the terms of the trust agreement. For instance, if the instrument specifies payment of certain indebtedness, the trustee must allocate money for that purpose.[4] The agreement should give the trustee power to meet emergencies connected with insurance policies. He should be able to obtain advances or loans on policies in order to pay the premiums. He should have power to surrender the policies for their cash values, and to release all interest in the policies upon the accomplishment of their purposes.[5]

With regard to the trustee's compensation, the American Bankers Association states that two methods of figuring fees are commonly used in business insurance trusts.

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1. I.T.B. #3 - p.19,20
2. I.T.B. #3 - p.28
3. I.T.B. #3 - p.31
4. Boston Life Insurance Trust Council Notes
5. Pro. 12th - 1931 - p.101

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"A. Where such trusts involve merely the deposit of stock and/or insurance policies which are payable to the trustee, with no action until the death of the partner or stockholder, and then only the collection of the proceeds of the policies by the trustee and the payment of same, and the delivery of the stock to the respective parties entitled thereto, the fees should be 2% on the amount of insurance collected. In addition, where stock is deposited, an annual fee on the par value thereof should be charged at the following rates:

1/20% per annum on par value up to $100,000
1/50% per annum on par value from $100,000 to $500,000
1/100% per annum on par value on all over $500,000

Stock of no par value will be taken at $100 par value."[1]

B. Where the same conditions apply but require the trustee to continue all or part of the insurance proceeds in trust, then in addition to the foregoing fees, the trustee should receive the same fees on principal and income as for voluntary trusts, for which the fees are commonly computed annually on income as follows:[1]

"5% on the first $100,000
2½% on the next $900,000
2% on the next $24,000,000 and over"

Half of the fee on principal (computed at the same rates) should be collected at the establishment of the trust and at any later additions, and the other half at distribution.[1]

The fee schedule of the Corporate Fiduciaries Association of New York City differs slightly from Method A given

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"A. Where such trusts involve merely the deposit of stock and/or insurance policies which are payable to the trustee, with no action until the death of the partner or stockholder, and then only the collection of the proceeds of the policies by the trustee and the payment of same, and the delivery of the stock to the respective parties entitled thereto, the fees should be 3% on the amount of insurance collected. In addition, where stock is deposited, an annual fee on the par value thereof should be charged at the following rates:

1/20% per annum on par value up to $100,000
1/30% per annum on par value from $100,000 to $500,000
1/100% per annum on par value on all over $500,000

Stock of no par value will be taken at $100 per value."[1]

B. Where the same conditions apply but require the trustee to continue all or part of the insurance proceeds in trust, then in addition to the foregoing fees, the trustee should receive the same fees on principal and income as for voluntary trusts, for which the fees are commonly computed annually on income as follows:[1]

"5% on the first $100,000
3% on the next $900,000
2% on the next $4,000,000 and over"

Half of the fee on principal (computed at the same rates) should be collected at the establishment of the trust and at any later additions, and the other half at distribution.[1]

The fee schedule of the Corporate Fiduciaries Association of New York City differs slightly from Method A given

1. A.B.A. - "Guide to Trust Fees"

above in that instead of charging a flat rate of 2% on insurance collected, it regulates the charge as follows:

1 1/2% on the first $50,000
1 % on the next $200,000
3/4% on the next $250,000
1/2% on all over $500,000

The additional fee on the par value of stock deposited is the same as in Method A.

With regard to a revocation fee, the trust agreement should name a given sum, varying with the size and complications of the trust, which will compensate the trustee "for the time and trouble involved in revoking the trust, redelivering the insurance policies and stock, and getting the trust closed on its books."[1]

The trustee should also receive an adequate setting up fee for the business insurance trust.[2]

The trust agreement often provides that the trustee's fee and all other expenses shall be paid from the insurance proceeds before the decedent's estate receives the balance. Sometimes, however, the surviving associates pay the fee. It would be more equitable to divide the fee proportionately between the decedent's estate and the surviving associates.[3]

XV. Certain Practical Aspects.--It is essential that the associates should have the complete coöperation of the life underwriter, the trustee, and their own attorney in planning

1. "100 Questions and Answers" - #84, p.78
2. "100 Questions and Answers" - #86, p.80
3. "100 Questions and Answers" - #85, p.78

above in that instead of charging a flat rate of 3% on insurance collected, it regulates the charge as follows:

1 1/3% on the first $30,000
1 " on the next $300,000
3/4% on the next $330,000
1/8% on all over $300,000

The additional fee on the par value of stock deposited is the same as in Method A.

With regard to a revocation fee, the trust agreement should name a given sum, varying with the size and complications of the trust, which will compensate the trustee "for the time and trouble involved in revoking the trust, redelivering the insurance policies and stock, and getting the trust closed on its books."[1]

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1. "100 Questions and Answers" - ¶84, p.78
2. "100 Questions and Answers" - ¶88, p.80
3. "100 Questions and Answers" - ¶88, p.78

a satisfactory business insurance trust. Usually the underwriter initiates the business insurance trust, although the trust officer may explain to a client the advantages of such a trust in a given situation. The underwriter with his background of training and experience should first obtain the financial rating of the concern or a copy of its financial statement, and should then analyze the business to determine how much business insurance there should be.[1] The underwriter's path may be smoother if he succeeds, with the permission of the business associates, in convincing their attorney of the advantage of such a trust and securing the latter's coöperation in working out the details of the trust agreement with the trustee and the clients.[2] Under no circumstances will the insurance company prepare the business insurance trust agreement alone - partly because laws vary greatly in different states, partly because a policyholder cannot expect an insurance company to prepare his private papers. "Some companies submit skeleton forms or specimen agreements, but others do not believe that this is advisable because the parties are too likely to follow them blindly and without consulting a lawyer."[3]

Probably the chief drawback in writing business insurance in general is its high lapse ratio, due usually to an

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1. Manning Manse - 1929 - p.35
2. T. Cos. - Dec. 1930 - J.W.White
3. "100 Questions and Answers" - #57, p.53

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1. Manning Manse - 1939 - p.38
2. T. Coe. - Dec. 1930 - J.W.White
3. "100 Questions and Answers" - 1937, p.33

incomplete understanding of the terms and advantages of the agreement, a lack of proper set-up, a lack of proper provision for paying premiums, or the "lapsation" of insurance (the allowing insurance to lapse) on the several surviving partners in a partnership when one partner's death has ended the agreement. However, it is claimed that business insurance lapsation is less common where a business insurance trust agreement has been drawn up naming a corporate fiduciary as trustee, because this trustee can often persuade the client not to lose the advantages of the agreement by allowing his insurance to lapse.[1] The high lapse ratio is expected to decrease as trust agreements become more carefully planned through the increased experience of underwriters and trustees.[2]

The trust company should insist that the interested parties consult their own attorney in planning and carrying out the business insurance trust instead of using the bank's legal department.[3] Otherwise "the legal department will be doing an immense amount of work for which it has neither the opportunity nor the right to charge compensation, and in the end will have business insurance trusts on its books built to endure for many years, but with the regular lawyers of the parties interested, who ought to have been consulted, under strong temptation to act as hostile critics rather than as

1. I.T.B. #3 - p.38
2. "100 Questions and Answers" - #86, p.80
3. I.T.B. #3 - p.39

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2. "100 Questions and Answers" - #86, p.80
3. I.T.B. #3 - p.39

friendly advisors."[1]

Another highly practical aspect needing consideration is the cost to trust companies of obtaining business insurance trusts. One authority says: "If we spend $10,000 annually in getting life insurance trusts, we should get at least $3,000,000 of insurance on our books each year. In counting annual expenditure I think we ought to count something for the overhead and for the clerical work in the office as well as for the purely advertising and soliciting expense."[2]

Another authority has worked out the value of the trust solicitor's time as compared with the value of the trust. The present worth of $50,000 of insurance placed in trust is $40. If the solicitor receives 20% of this (as salesmen do in other lines of business) he gets $8. The solicitor must secure a trust of that size in order to "make good". If he receives $500 salary a month, he gets $2.73 per working hour.[3] Thus "he will have to hustle to close up the business in a little less than three hours to justify his pay; but if, from the time he gets the lead to the time the dotted line is mutilated, he has consumed more than fifteen hours, the trust company has lost money and the solicitor might as well have gone fishing, to say nothing of the delightful time spend by highly paid officials in entertaining prospects having diver-

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1. I.T.B. #3 - p.9
2. I.T.B. #3 - p.39
3. T. Cos. - Sept. 1931 - C. Alexander - p.305,306

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Another authority has worked out the value of the trust solicitor's time as compared with the value of the trust. The present worth of $50,000 of insurance placed in trust is $40. If the solicitor receives 80% of this (as salesmen do in other lines of business) he gets $8. The solicitor must secure a trust of that size in order to "make good". If he receives $800 salary a month, he gets $3.72 per working hour. Thus "he will have to hustle to close up the business in a little less than three hours to justify his pay; but if, from the time he gets the lead to the time the dotted line is initiated, he has consumed more than fifteen hours, the trust company has lost money and the solicitor might as well have gone fishing, to say nothing of the delightful time spend by highly paid officials in entertaining prospects having diver-

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1. I.T.S. #3 - p.3
2. I.T.S. #3 - p.39
3. T. Cos. - Sept. 1931 - O. Alexander - p.309,306

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Perhaps the principal advantages to a trust company of obtaining business insurance trusts lie in their by-products of personal insurance trusts, trusts under wills, and increased commercial banking,[2] although some trustees believe that the cost per item of business so obtained is probably higher than if that business were solicited directly and the business insurance trust were secondary.[1] In a study recently made by Mr. Leslie G. McDouall of 35 outstanding trust executives located in 23 cities and 17 states, more than half believed that in the long run the business insurance trust is unprofitable. "They are fraught with difficulty, if not danger, and are nearly always unsound as they have been generally advocated."[3] But although some executives merely replied: "More important to the client than to our bank," others said: "The collateral business we are able to obtain justifies our taking on this class of business."[3]

One writer on the subject who does not believe that business insurance trusts are profitable has claimed that although the volume of business insurance itself was increasing, the volume of business insurance trusts with a corporate trustee was hardly holding its own. "The average amount of such new business in 56 leading trust companies in 1930 was $500,000.[1] The average amount of insurance deposited under

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1. T. Cos. - Sept. 1931 - C. Alexander - p.305,306
2. "100 Questions and Answers" - #86, p.79,80
3. Pro. 13th - 1932 - p.79,80

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1. T. Cos. - Supt. 1931 - C. Alexander - p.305,308
2. "100 Questions and Answers" - 1928, p.78,80
3. Pro. 15th - 1933 - p.78,80

each such trust agreement in the larger cities was about $55,000, and in the smaller cities about $30,000. It is hardly more than 3% of the personal trust business. If each business insurance trust had produced its volume in other personal trust business (which it did not) the amount of such business would have been less than $500,000 for each trust company, and the cost of obtaining it would closely approximate its present value. Verily, those who advocate such an approach to new business must believe in the theory that the tail really does wag the dog."[1]

The same writer has stated: "Where both members of a firm are 45 years old, the total present value of their business insurance trusts to the trust company per $1,000 of all insurance deposited thereunder is about 80¢. For three associates the value is less than two-thirds of that figure."[1] Yet in spite of these factors, he urged trust companies to think of the family's welfare in each case. "Take business insurance trusts that are sound from the standpoint of the family, and give your best service to them. You will probably lose money on it, but it is a service that you offer your fellow-man, and it will not be the first time you have lost."[1]

From the business man's viewpoint business insurance trusts are not a universal panacea for worries on an associate's death. Yet because they solve many problems as

1. T. Cos. - Sept. 1931 - C. Alexander - p.305,306,308

each such trust agreement in the larger cities was about $35,000, and in the smaller cities about $20,000. It is hardly more than 3% of the personal trust business. If each business insurance trust had produced its volume in other personal trust business (which it did not) the amount of such business would have been less than $300,000 for each trust company, and the cost of obtaining it would closely approximate its present value. Verily, those who advocate such an approach to new business must believe in the theory that the tail really does wag the dog."[1]

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1. T. Coe. - Sept. 1931 - O. Alexander - p.302,303,308

nothing else seems to do, their value should be determined separately for each case.

Probably if costs and fees for business insurance trusts are studied more closely, some way may be found to cover costs without charging too high a price. Charges based on such a scientific study would assure a recognized profit on business insurance trusts and therefore would make them far more popular with trustees.

XVI. Field for Future Development.--Few business insurance trusts have yet been tested by actual experience. Many trust officers and life underwriters believe that one reason why the field for business insurance trusts is less broad than for personal insurance trusts is because business insurance trust agreements are so much more complicated that the average underwriter and his prospect cannot understand them. However, competent underwriters are increasing. Although some authorities claim that "business insurance will probably sell itself less than any other kind of insurance," questions from mailing-list advertising about business insurance trusts have been greater in percentage than questions about personal insurance trusts. It has been estimated that less than 1% of the potential business insurance has been written.[1]

An excellent, comparatively new field for business insurance trusts exists in the professions - partnerships in

1. "100 Questions and Answers" - #99, p.89,90

legal firms, medical clinics, etc. An underwriter says that such trusts seem "the only method for the settlement of the deceased member's interest in the Goodwill and resultant income of the partnership. This field seems to have been covered very little and we have had unusual success in securing business in this manner with the coöperation of the incorporated fiduciary."[1]

It is true that "the development of the business insurance trust has not kept pace with the personal insurance trust."[2] Probably this fact is caused not only by the difficulty of thorough comprehension of the business insurance trust, but also by the necessity for convincing all the key men of each firm of the merits of the trust,[2] whereas the personal insurance trust demands a conversion to faith on the part of only one individual.

The business insurance trust field should be developed from an economic standpoint as well as from the one of profit for the trust company, because: the success of this movement will add stability to business; it will assure a fair market for the close corporation stocks of deceased clients whose estates are in a trust company's charge; it will relieve trust companies of "the burden of trying to run the business" (instead of undertaking to handle such business as trustees under wills) "with the countless worries such efforts entail."[2]

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1. I.T.B. #3 - p.35
2. T. Cos. - Dec. 1930 - J.W.White

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1. I.T.B. #5 - p.85
2. T. Coe. - Dec. 1920 - J.W.White

The surviving members of the concern are free to continue the business without intermeddling by the families of deceased associates. Gradually over the years the business insurance trust will take its place in the business world as a necessity, just as fire insurance is considered a necessity today."[1]

1. T. Cos. - Dec. 1930 - J.W.White

The surviving members of the concern are free to continue the business without intermeddling by the families of deceased associates. Gradually over the years the business insurance trust will take its place in the business world as a necessity, just as life insurance is considered a necessity today."

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1. T. Cos. - Dec. 1930 - J.W.Mairs

PART II. TYPICAL THEORETIC CASES

FOREWORD

The cases in Part II of this thesis have been adapted from information gained from many sources, as follows:

Leon Gilbert Simon: "Business Insurance"

Insurance Trust Bulletin #3 - March, 1929

Atlantic National Bank: "Proved Plans for Solving Estate Problems"

Old Colony Trust Company: "Life Insurance in Relation to Your Estate"

State Street Trust Company: "Business Insurance"

"Proceedings of a Selected Group of Life Underwriters at Manning Manse, October 18, 1929"

"A Verbatim Report of a Joint Meeting of Life Underwriters and Officers of the Trust Department of the Atlantic National Bank of Boston at the Manning Manse, November 12, 1930"

"The Spectator" - September 17, 1931

Cases discussed at meetings of the Boston Life Insurance Trust Council, 1932

From this varied material I have compiled here typical cases to illustrate the application of business insurance principles to specific uses. In most of the cases, therefore, the facts given either represent only an especially apposite section out of the total problems furnished by the case, or else show the whole case slightly distorted, like a railroad map, in order to stress the desired aspects.

PART II. TYPICAL THEORETIC CASES

FOREWORD

From this varied material I have compiled here typical cases to illustrate the application of business insurance principles to specific uses. In most of the cases, therefore, the facts given either represent only an especially apposite section out of the total problems furnished by the case, or else show the whole case slightly distorted, like a railroad map, in order to stress the desired aspects.

CASE 1. Perpetuation of Single Proprietorship Business.--
The sole proprietor, A, of a grocery store worth $45,000, wishes that his business could continue after his death. He wishes his wife to have a steady income without the responsibility of running the business herself, and he has no children to look after her interests. A has three very capable clerks who could easily run the business if they do not decide to strike out for themselves after A's death. Therefore A makes a business insurance trust agreement with these clerks. Each clerk takes out a $15,000 insurance policy on A's life, payable to the same specified trust company as trustee. The trust agreement provides that upon A's death the trustee shall collect the insurance proceeds and pay them to A's estate in return for A's entire rights in the business. The trust company shall then transfer to A's three clerks the complete title to the business, to be held by them jointly. This agreement binds A and his heirs and representatives to sell A's business to the clerks in the way specified.

Comment: The knowledge of the existence of such an agreement, shared by clerks and proprietor, will tend to hold the clerks to the business not only after the proprietor's death but during his lifetime, and will make them feel that their interests are interlocked with his and with each others' and will promote an atmosphere of teamplay and good feeling.

CASE 2. Retirement of Individual's Note.--When A wishes to borrow $50,000 for six months from B, giving B a promissory note for the amount, B is afraid that if A should die during that time, it would be impossible for B to collect the note from A's estate. Therefore B only agrees to lend A the money upon condition that A shall establish a business insurance trust, depositing with the trustee a $50,000 insurance policy on A's life, payable to B, as collateral to the note for $50,000. The trust agreement provides that upon the maturity and payment of the note, if A is still alive, B will reassign the policy to A. If A dies before the six months are up, the trustee will pay the insurance proceeds to B, and return the cancelled note to A's estate.

Comment: This use of business insurance is applicable to any insurable individual, whether he is a business man or not, and is closely allied to the assignment of a personal insurance policy as collateral to secure a loan.

CASE 3. Surviving Partner Buys Out Decedent's Interest.--A and B are equal partners in a rapidly growing business now worth $50,000. They know that for several years most of the profits should be ploughed back into the business, so that their drawings for living expenses must be kept small. If A should die suddenly, leaving his interest to his wife, B would have the entire responsibility of the organization, the expense of a man to take A's place, and the problem of either

buying out A's widow or paying her a steady income on A's share. B might find it impossible to raise sufficient money to buy A's interest without crippling the business, while A's widow might insist on receiving her entire half of the profits each year, instead of using them to build up the organization for the future. Therefore A and B decide to establish a business insurance trust as the solution to their problem. Each insures the other for $35,000, payable to their trust company as trustee. They also draw up a written trust agreement providing that each shall insure the other and that the trust company shall pay the proceeds to the decedent's estate toward the decedent's share in the business. The partners agree to file semiannual financial statements showing the value of each partner's share, and also agree that the value shown in the most recent of these will be the value at the death of either partner and the purchase price of his business interest. If the insurance on the decedent's life is not enough to pay for his interest, the surviving partner will give the deceased's estate a series of notes for the balance, payable over as short a time as possible. Thus if A dies first, B will get full title to the business after A's share is easily paid off; and A's widow will receive a definite principal which should, if invested wisely, bring her enough income to keep her from want.

CASE 4. Insurance Payable to Partnership Under Oral Purchase Agreement.--A, B, and C are equal partners in a $60,000 business. They desire to plan so that the surviving associates can buy out any partner's interest at his death. Therefore they have the partnership insure each individual partner for $20,000, payable at his death to the firm. They agree orally that the surviving partners will pay this money to the decedent's estate.

Comment: The partnership should not carry the insurance on the individual partners; instead, each partner should insure the others. The proceeds should be payable to a bank as trustee to carry out the associates' agreement of purchase by the surviving members, because creditors may be able to reach insurance proceeds payable to the firm. Also, insurance paid to the partnership becomes a business asset and increases each partner's interest. The oral purchase agreement of A, B, and C is highly dangerous, because they may forget or misunderstand its terms - or may intentionally disregard them. Instead, the agreement should be drawn up in writing by a competent lawyer who will know how to express the partners' wishes.

CASE 5. Senior Partner Loans Premiums for Minimum Insurance.--A has a two-thirds interest and B a one-third interest in a $90,000 partnership. A, a well-to-do bachelor, can easily afford to carry $30,000 life insurance on B to retire

CASE 4. Insurance Payable to Partnership Under Cross Purchase Agreement.--A, B, and C are equal partners in a $80,000 business. They desire to plan so that the surviving associates can buy out any partner's interest at his death. Therefore they have the partnership insure each individual partner for $80,000, payable at his death to the firm. They agree orally that the surviving partners will pay this money to the deceased's estate.

Comment: The partnership should not carry the insurance on the individual partners; instead, each partner should insure the others. The proceeds should be payable to a bank as trustee to carry out the associates' agreement of purchase by the surviving members, because creditors may be able to reach insurance proceeds payable to the firm. Also, insurance paid to the partnership becomes a business asset and increases each partner's interest. The oral purchase agreement of A, B, and C is highly dangerous, because they may forget or misunderstand its terms - or may intentionally disregard them. Instead, the agreement should be drawn up in writing by a competent lawyer who will know how to express the partners' wishes.

CASE 5. Senior Partner Forms Premiums for Minimum Insurance.--A has a two-thirds interest and B a one-third interest in a $80,000 partnership. A, a well-to-do bachelor, can easily afford to carry $80,000 life insurance on B to retire

B's interest at B's death, but B, a young man with a family to raise, cannot afford to carry any life insurance at all on A to retire A's $60,000 interest. Yet A is 60 years old and not very strong, so that it may not be long before B may have to meet this problem of retiring A's interest. Therefore A not only insures B for $30,000, but agrees to lend B each year the premium necessary to insure A for $40,000. B insures A for only $40,000 in order to keep his borrowed premiums as low as possible. B gives A a collateral assignment of the $40,000 policy so that if B dies first, A will get back the loaned premiums. The partners draw up a business insurance trust agreement, naming a bank to oversee the settlement and providing that B will pay the balance of A's interest plus all the borrowed premiums over a given term of years, or if and when B should sell all or part of A's interest to some new partner of B's own choosing.

Comment: In such a case A has clearly two purposes in mind, first, to maintain the business for the sake of tradition and of its employees, second, to give B a "fair show" in carrying it on.

CASE 6. Premiums Advanced Through Drawing Account.--In the ABC Company, A has a 60% interest ($72,000), B a 25% interest ($30,000), and C a 15% interest ($18,000) in the $120,000 partnership. They wish to establish a business insurance trust, each insuring the others; but although A and

B can easily carry insurance on each other and on C, C cannot afford to carry any insurance. The partners agree that C may draw enough additional money through his drawing account in the firm to pay the premiums on his share of the insurance on A and B. They state this in the trust agreement and provide that C will repay these extra drawings when the growth of the business has let the partners increase the amount of their regular drawings. Because the partners wish the surviving members' proportionate shares in the business to continue the same, they insure each other as follows:

Insurers	Insured A	Insured B	Insured C	Totals Paid For
A		$24,000	$12,700	$36,700
B	$45,000		5,300	50,300
C	27,000	6,000		33,000
Totals	$72,000	$30,000	$18,000	$120,000

Thus A pays premiums on $36,700 and is insured for $72,000; B pays for $50,300 and is insured for $30,000; and C must pay for $33,000, while he is insured for $18,000. This distribution keeps the proportions of the investment of any two surviving associates in the life of the third associate the same as their relative investments in the company.

CASE 7. Uninsurable Associate.--A, the senior member of the ABC Company, has heart trouble and is therefore uninsurable. A, B, and C wish to set up a business insurance trust to retire the interest of each associate at death. The underwriter and trust officer suggest two plans to meet the

Insures	A	Insured B	C	Total Paid For
A		$84,000	$18,700	$36,700
B	$45,000		3,300	30,300
C	37,000	6,000		33,000
Totals	$72,000	$90,000	$18,000	$130,000

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case in spite of A's condition. According to the first plan, A and B will insure C for his interest, and A and C will insure B. When they pay the annual premiums on these policies, they will set aside in the savings bank an equal amount as a reserve to accumulate toward A's interest. This reserve will be small at first, but if A lives for several years, it may become a good-sized sum.

The second plan, which calls for no cash reserve, provides for carrying additional insurance on B and C. Then if A dies first, B and C will cash in this extra insurance on their own lives for its cash surrender value, whereas if B or C should die first, the proceeds of the decedent's extra insurance would remain in the hands of the trustee until A's death, when the trustee would deliver it to the one surviving associate.

CASE 8. Estate Insufficient to Purchase Decedent's Interest.--The three closely related owners of the ABC department store have all recently died without wills. A's childless widow and the childless widows of B and C, each having inherited one-half of her husband's estate, together own a one-half interest in the store; and they have an option to purchase the remaining half-interest, worth $100,000, within six months after the last owner's death. In each case the owner, while living, expressed to his wife a wish that his interest should be kept by her during her life and then be-

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CASE 8. Estate Sufficient to Purchase Decedent's Interest.--The three closely related owners of the ABC department store have all recently died without wills. A's children, widow and the children-in-law widows of B and C, each having inherited one-half of her husband's estate, together own a one-half interest in the store; and they have an option to purchase the remaining half-interest, worth $100,000, within six months after the last owner's death. In each case the owner, while living, expressed to his wife a wish that his interest should be kept by her during her life and then be-

queathed to his relatives. However, it happens that as no provision has ever been made to assure cash for that purpose, the heirs of the associates have as their only valuable assets two pieces of real estate totaling $60,000 with which to take up the $100,000 option.

Comment: This unfortunate situation could not exist if A, B, and C had thought to draw up a business insurance trust, insuring each other for a total of $100,000, the value of the half interest which would otherwise pass into other hands. The three original owners should have made the insurance payable to a bank as trustee, instructing the trustee to use the proceeds in taking up the purchase option for the benefit of the owners' heirs. Now the only possible solution is for the widows to borrow on their respective interests in the business, taking out protective insurance themselves, as in Case 2, to retire these notes in case of death.

CASE 9. Purchase Option Not an Obligation.--Two young men, A and B, were partners. They had an option to purchase the stock of a competing corporation within ten years for $60,000, but they were under no obligation to buy it. They planned to guarantee this purchase by insuring each other for $30,000 apiece and by setting up a business insurance trust. Yet in the trust agreement they merely specified that after all "obligations due" at the death of either partner had been paid, the trustee should pay any balance to the deceased

partner's widow. The agreement did not mention the purchase option. Two years later A was divorced, and soon after was killed in an automobile accident. A's entire estate consisted of the $30,000 insurance, which he had intended B to use in taking up the purchase option. However, because the option was not an "obligation due", A's divorced wife was able to collect the entire $30,000 for her own purposes. B, who was thus short half the option money, was unable to obtain it elsewhere. B struggled, short-handed, for a while, but presently he let things drift and at last was foreclosed.

Comment: If the business insurance trust agreement had been properly drawn to express the wishes of the parties, specifying the use of the insurance to take up the purchase option, B would have received the money for this purpose. This one omission was enough to spoil both partners' plans.

CASE 10. Policies Issued Before Drawing Trust Agreement.--A, B, and C each owned one-third of the stock in the $120,000 ABC Corporation. They wished to keep the business in the hands of the two surviving stockholders after the death of one. Each stockholder insured each other stockholder for $20,000, so that A, B, and C were each insured for $40,000 - the value of each man's stock. The policies were issued immediately, to protect the associates while working out the details of a business insurance trust, and were temporarily made payable to the corporation until the stockholders agreed

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CASE 10. Policies Issued Before Drawing Trust Agreement.--- A, B, and C each owned one-third of the stock in the $150,000 ABC Corporation. They wished to keep the business in the hands of the two surviving stockholders after the death of one. Each stockholder insured each other stockholder for $30,000, so that A, B, and C were each insured for $60,000 - the value of each man's stock. The policies were issued immediately, to protect the associates while working out the details of a business insurance trust, and were temporarily made payable to the corporation until the stockholders agreed

on a bank as trustee. The business insurance trust agreement was being carefully drawn, to provide that upon the death of each stockholder, the trustee should collect his $40,000 insurance proceeds and pay this money to the deceased stockholder's estate in return for his stock. The trustee should then transfer that stock to the surviving stockholders. When the trust agreement was signed, A, B, and C were to change the beneficiary of their insurance from the corporation to the trustee, and also deposit their stock with the trustee in escrow until their deaths. But B died before the agreement was signed - thus altering the taxation and inheritance situation, as discussed in Part I, Section VIII, Problems 36 and 45 of this thesis.

Comment: In cases where immediate protection is so essential that the policies are issued before the trust agreement is drawn, a moral obligation rests on the life underwriter to see that the parties actually accomplish the full purpose of the insurance by drawing the trust agreement (unless one party dies first, as in this case). He must also make sure that the policies are then made payable to the trustee.

CASE 11. Premium Distribution According to Stock Ownership.--In the ABC Company A, 58 years old, owns 60% ($126,000), B, 45 years old, owns 30% ($63,000), and C, 32 years old, owns 10% ($21,000) of the stock in the $210,000 corporation. They

on a bank as trustee. The business insurance trust agreement was being carefully drawn, to provide that upon the death of each stockholder, the trustee should collect his $40,000 insurance proceeds and pay this money to the deceased stockholder's estate in return for his stock. The trustee should then transfer that stock to the surviving stockholders. When the trust agreement was signed, A, B, and C were to change the beneficiary of their insurance from the corporation to the trustee, and also deposit their stock with the trustee in escrow until their deaths. But B died before the agreement was signed - thus altering the taxation and inheritance situation, as discussed in Part I, Section VIII, Problems 36 and 45 of this thesis.

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CASE 11. Premium Distribution According to Stock Ownership.--In the ABC Company A, 58 years old, owns 60% ($150,000), B, 45 years old, owns 30% ($75,000), and C, 33 years old, owns 10% ($25,000) of the stock in the $250,000 corporation. They

form a business insurance trust, providing that each stockholder shall pay premiums on insurance to cover his proportionate amount of his two associates' shares in the corporation, as shown in the accompanying chart.

Insurers	Insured A - 60%	Insured B - 30%	Insured C - 10%	Totals Paid For
A		6/7 $54,000	2/3 $14,000	$68,000
B	3/4 $94,500		1/3 7,000	101,500
C	1/4 31,500	1/7 9,000		40,500
Totals	$126,000	$63,000	$21,000	$210,000

Thus the premiums on A's $126,000 are paid 3/4 by B and 1/4 by C; those on B's $63,000 6/7 by A and 1/7 by C; and on C's $21,000 2/3 by A and 1/3 by B. By this plan A, B, and C avoid paying premiums on insurance to cover their own stock, and gain the advantages (already discussed in Part I) of having the premiums paid by individuals instead of by the corporation. The business insurance trust agreement provides that upon the death of one of the three stockholders, the bank named as trustee shall collect his insurance, deliver it to his personal insurance trust, and deliver his stock to the two surviving stockholders in the same proportions in which they have paid premiums on the deceased's life. The proportionate ownership of these two stockholders with regard to each other will thus remain unchanged. This case resembles in its apportionment of premiums and business interest the partnership case outlined in Case 6.

CASE 12. Wife's Minority Stock Handled With Deceased Husband's Shares.--A owns 45 shares and B 40 shares of the

form a business insurance trust, providing that each stockholder shall pay premiums on insurance to cover his proportionate amount of his two associates' shares in the corporation, as shown in the accompanying chart.

Insurers	A - 50%	B - 30%	C - 10%	Totals Paid For
A		6/7 $84,000	3/3 $14,000	$98,000
B	3/4 $94,500		1/3 7,000	101,500
C	1/4 31,500	1/7 9,000		40,500
Totals	$126,000	$93,000	$21,000	$240,000

Thus the premiums on A's $126,000 are paid 3/4 by B and 1/4 by C; those on B's $63,000 6/7 by A and 1/7 by C; and on C's $21,000 3/3 by A and 1/3 by B. By this plan A, B, and C avoid paying premiums on insurance to cover their own stock, and gain the advantages (already discussed in Part I) of having the premiums paid by individuals instead of by the corporation. The business insurance trust agreement provides that upon the death of one of the three stockholders, the bank named as trustee shall collect his insurance, deliver it to his personal insurance trust, and deliver his stock to the two surviving stockholders in the same proportions in which they have paid premiums on the deceased's life. The proportionate ownership of these two stockholders with regard to each other will thus remain unchanged. This case resembles in its apportionment of premiums and business interest the partnership one outlined in Case 8.

CASE 13. Wife's Minority Stock Bundled With Deceased Husband's Shares.--A owns 45 shares and B 40 shares of the

100 shares of stock in a close corporation. For convenience Mrs. A holds 10 shares and Mrs. B holds 5 shares. A and B wish to plan some way whereby when one dies, the other will surely get the stock of both the decedent and the decedent's widow. Therefore they set up a business insurance trust agreement with A insuring B for the value of the B family's 45 shares and B insuring A for the A family's 55 shares. The insurance is payable to a bank as trustee for collection and disbursement in the usual manner, and the whole 100 shares of stock are deposited in escrow with the trustee to be held until the death of one party. Mrs. A and Mrs. B sign a supplementary agreement promising not to sell their stock to any outsider and promising to make wills leaving it to their respective husbands. Each wife also promises that if she outlives her husband, her stock will be transferred with her husband's to the surviving principal stockholder in return for the insurance proceeds as provided under the business insurance trust agreement.

CASE 13. Minority Survivor Obtains Half Interest.--In the ABC Company A owns one-half and B and C each one-fourth of the stock. The total capital stock of the corporation is worth $50,000 and there is a surplus of $32,400, making a total net worth of $82,400. Thus A's share of the net worth is $41,200, while B and C each have $20,600. The question arises as to the disposition of each stockholder's interest

at his death. A is not interested in buying more than his 50% of the stock, but B and C are in a very different position. In matters of policy B and C are far more progressive than A and have often struggled together to convince A of the advisability of some new project. They know that if B dies first and his stock goes to some outsider who fails to coöperate with C, then A's ideas will completely dominate the business. Therefore B and C insure each other for $20,000 under a business insurance trust agreement, so that no matter which dies first, the other can buy his stock and have an equal voice with A in the management of the business. They provide in the agreement that the survivor shall pay any balance of net worth in cash or notes.

CASE 14. Combined Stock Purchase and Shock-Absorber Insurance.--In the ABCD Company, all four stockholders, A, B, C, and D, are very active in the business, each holding a key position. They wish to form some plan of purchasing each man's stock upon his death and of compensating the company for the death of an important executive. They try to estimate the actual loss of efficiency and Goodwill which the corporation would incur if each stockholder died, and they add that sum to the value of his stock. The corporation then insures each man for his individual total, with the policies payable to a bank as trustee under a business insurance trust. The trust agreement rules that the bank will hold the stock

in escrow during the associates' lives, and that no stockholder can sell or hypothecate his shares without the written consent of all other stockholders. The corporation agrees to file semiannual financial statements with the trustee, the most recent of which shall always be considered to give the current value of the corporation's net worth. Thus at A's death, the trustee collects A's insurance, determines A's net worth from the most recent financial statements, and pays the value of that net worth to A's executor. The trustee then delivers to the corporation the remaining insurance, to compensate for the loss of A's services, and also transfers to it A's stock, to be carried as treasury stock or divided among the surviving stockholders as the corporation decides.

CASE 15. Special Cash Dividend to Pay Premiums.--A owns 60%, B 30%, and C 10% of the stock of the $120,000 ABC Corporation. The stockholders wish to set up a business insurance trust so that, as each dies, his shares will be bought by the others. B and C, however, cannot afford to pay insurance premiums. Therefore the corporation agrees to pay annually to each of the three stockholders a special cash dividend equal to his net premium outlay. This method is chosen rather than a salary increase because the special dividend more definitely indicates the reservation of that particular amount for the single purpose of premium payment.

CASE 16. Premium Reimbursement.--In the ABCD Corporation

CASE 15. Special Cash Dividend to Pay Premiums.---A owns 60%, B 30%, and C 10% of the stock of the $150,000 ABC Corporation. The stockholders wish to set up a business insurance trust so that, as each dies, his shares will be bought by the others. B and C, however, cannot afford to pay insurance premiums. Therefore the corporation agrees to pay annually to each of the three stockholders a special cash dividend equal to his net premium(ntly. This method is chosen rather than a salary increase because the special dividend more definitely indicates the reservation of that particular amount for the single purpose of premium payment.

CASE 16. Premium Reinsurance.---In the ABCD Corporation

A owns 60% of the stock, with 40% divided among B, C, and D. The corporation carries life insurance on A under a business insurance trust agreement which provides that upon A's death the designated trustee shall collect the insurance, pay to A's estate the value of his stock interest, and finally deliver A's stock to the corporation to be held as treasury stock. Because the insurance premiums are paid from corporate funds, and because A has an interest of 60% in the corporation, A has indirectly paid 60% of the premiums on insurance intended to liquidate his own interest. Therefore the trust agreement provides that at A's death his heirs shall receive, in addition to the value of A's stock interest, 60% of the total premiums paid by the corporation. The agreement rules that if the insurance proceeds are insufficient to pay this total, the insurance shall serve as the first payment and the corporation shall give the business insurance trustee a note for the balance, payable within five years. For example, suppose that A is insured for $90,000 and that the premiums have aggregated $15,000 over the five years that the insurance has been in force. The value of A's stock interest has now increased to $100,000. Therefore if A dies at this time, his heirs will have the right to claim, via the business insurance trustee, $100,000 + (60% of $15,000) = $109,000. The trustee will collect and pay out the $90,000 insurance proceeds immediately, and will demand a note for $19,000 from

the corporation, payable within five years. Under the trust agreement, the trustee shall hold A's stock for the benefit of A's heirs until the corporation has paid the full $19,000, after which the trustee shall transfer A's stock to the corporation.

CASE 17. Cash Values of Surviving Associates' Policies as Asset.--A owns 50% of the stock, B 30%, and C 20% in the ABC Company. Each carries insurance on the others' lives under a business insurance trust, so that when one dies, the insurance will be available to purchase his stock. If the total value of the business at A's death is $100,000, A's heirs will ultimately receive $50,000 for his stock. However, A's estate has a further asset gained from his business relations - the cash values of the policies which A has carried on B and C. The business insurance trust agreement provides that B and C shall have the right to purchase these policies for their cash surrender values within six months after A's death. After that time, the policies will be turned in to the insurance company for their cash surrender values and these proceeds paid to A's estate.

CASE 18. Retirement of Bond Issue.--A owns 75%, B 15%, and C 10% of the stock of the X Company. The corporation wishes to secure additional funds through putting out a 20-year bond issue of $100,000. However, because A is for all practical purposes the sole proprietor of the business and is

the final authority in making all important decisions, no investment house dares to float the issue without some guarantee that A's death before the maturity of the bonds would not cause the company to default on the retirement of the issue. Therefore the X Company takes out a 20-year endowment insurance policy on A's life for $100,000 and creates a business insurance trust with its bank as trustee. The trust agreement provides that the endowment policy shall be used to retire the bond issue, and that if A dies within the twenty years, the bonds shall be immediately callable for redemption by the trustee from the insurance matured on account of A's death. This arrangement proves entirely satisfactory to the investment house which previously had hesitated to float the bond issue.

CASE 19. Stock Control Saved to Heirs of Insolvent Estate.--A, who owned 60% of the stock of a close corporation founded by his grandfather and kept strictly in the family, was forced during the depression, with the family's approval, to pledge his entire holdings of this stock as security for a bank loan. A sudden stock market crash wiped out all his other investments and left him in debt, and the shock caused his death from heart failure. The executor found that A's estate was insolvent, and that although his stock in the small family corporation still had steady earning power with great potential value, A's estate itself had no money to re-

deem this stock. The bank at once instituted foreclosure proceedings. Several years earlier, however, the minority stockholders had joined with A in a business insurance trust, so that when any stockholder died, the others could purchase his interest and keep the stock in the family. Therefore the business insurance trustee, with the approval of the surviving stockholders, used the insurance proceeds to redeem A's stock, preventing the bank's foreclosure sale, thus keeping the control of the business in the family and saving for A's heirs and business associates a satisfactory present income with a certain future appreciation of principal.

CASE 20. Chance for Son in Close Corporation.--A owns 90% of the stock in the small, close corporation which he formed when he incorporated his single proprietorship business a few years before. At that time he divided the other 10% of the stock equally between his two chief employees. A wishes his only son to succeed him in control of the business but does not wish to force this duty on his son if the boy's interests definitely turn in other directions. Therefore A sets up a business insurance trust with his bank as trustee. The two minority stockholders carry insurance on A's life for the value of 38% of the stock in the organization. The trust agreement provides that at A's death both the insurance proceeds and A's stock shall be paid to the trustee, who shall at once divide 38% of the stock equally between the two

CASE 80. Change for Son in Close Corporation.--A owns 80% of the stock in the small, close corporation which he formed when he incorporated his single proprietorship business a few years before. At that time he divided the other 10% of the stock equally between his two chief employees. A wishes his only son to succeed him in control of the business but does not wish to force this duty on his son if the boy's interests definitely turn in other directions. Therefore A sets up a business insurance trust with his bank as trustee. The two minority stockholders carry insurance on A's life for the value of 38% of the stock in the organization. The trust agreement provides that at A's death both the insurance proceeds and A's stock shall be paid to the trustee, who shall at once divide 38% of the stock equally between the two

minority stockholders. The trustee shall pay the insurance proceeds into A's personal insurance trust for his wife, but shall act with the minority stockholders in managing the business until A's son becomes 25 years old. If A's son wishes to take an active interest in the business, the trustee shall then transfer to him the remaining 52% of the stock; if he is not interested in the business, the trustee shall give the minority stockholders an option on the stock for a year with payments extending over a term of years to be determined by the stockholders, the son, and the trustee, before offering it to outsiders. The proceeds of sale shall be paid to A's son in full settlement of his share in his father's estate. If A's son should die before his twenty-fifth birthday (but after A's death), a similar one-year purchase option will at once be offered to the minority stockholders. In this case the proceeds of sale shall be added to the personal trust for A's widow. By this method A assures the continued interest of two capable men in his business, and gives his son the opportunity to step into A's shoes when the boy has completed his education.

PART III. BUSINESS INSURANCE TRUSTS IN ACTUAL PRACTICE

FOREWORD

In Parts I and II, I tried to set forth fully the generally accepted theories about business insurance trusts as expressed by recognized authorities in print and at public meetings. Many of the theories, however, seemed to me to furnish ground for interesting discussion and for a possible diversity of opinion in the viewpoints both of individuals who had had actual experience in constructing and administering the trusts, and of the two groups, insurance men and banking men, who in other trust matters have not always seen eye to eye. Therefore in personal interviews I presented the problems to the business insurance trust specialists of five leading Boston corporate fiduciaries and to five prominent business insurance underwriters (three of them writers of textbooks and articles on the subject). I asked these ten men to answer a set of twenty definite questions on the basis of their actual individual knowledge and experience. The questions and their answers I have briefly summarized to form Part III.

It will be clear that in many cases the answers are bewilderingly varied. Wherever the consensus of experience has furnished a clean-cut result, I have stated the conclusion reached, but in the cases where any brief summing up would

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prove misleading, I have been forced to let my verbatim reports of the interviews speak for themselves.

The bank officials whom I interviewed and the banks whose policies they represented were:

Mr. Roy H. Booth--National Shawmut Bank of Boston
Mr. Thomas G. Brown--New England Trust Company
Mr. Basil S. Collins--Old Colony Trust Company
Mr. Frank Lynch--State Street Trust Company
Mr. George E. Coates--until recently Life Insurance Trust Officer of the Atlantic National Bank of Boston

The business insurance underwriters interviewed were:

Mr. Harold Cooley--New England Mutual Life Insurance Company
Mr. Franklin W. Ganse--John Hancock Mutual Life Insurance Company
Mr. Earl G. Manning--John Hancock Mutual Life Insurance Company
Mr. Ralph H. Sanborn--Connecticut Mutual Life Insurance Company
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1. Why is the lapse ratio of business insurance trusts high?

Two underwriters and one trust officer did not consider the lapse ratio of business insurance trusts high, but the other seven men interviewed felt that the chief cause of recent lapses was undoubtedly the business depression. One trust officer definitely felt that imperfect agreements caused the high lapsation, but a life underwriter said that "you cannot tell whether or not the agreement is imperfect until a competitor points it out to the business associates or until it becomes a claim at death;" and he added that as yet very few business insurance trust death claims have been made. Four of the seven men gave such interesting analyses of the matter that I shall quote them practically in full.

A trust officer in a long-established trust company said: "The shrinkage in earnings has got to the point where people feel that they cannot pay their premiums, and they are rather doubtful as to the worth of the business anyway. Also that worth is changing too rapidly."

An underwriter who has written authoritatively about business insurance trusts added the comment: "Although a business insurance trust is part of the overhead of the business, it cannot be charged off as an operating expense. The plant or institution does not have to stop running if it does not pay the premiums. Therefore business insurance trusts

are put in the luxury class, commercially speaking, no matter how much good they have done the firm. If the business insurance trust plan has actually been 'sold', and sold with difficulty, the institution which has it is bound to weaken on it compared to a lot of other expenses that they might feel were more important - with the exception of those few isolated organizations where death claims have already been paid on business life insurance. In such cases you could not get them to part with it. Also the experience of business insurance trusts is not great enough to make firms feel that these trusts should be estimated as in the same class with fire insurance."

Another underwriter stated that "shock-absorber insurance" was the type most likely to lapse. "In good times they view the earning genius with awe, but when times get bad, three years later, the same individual who was a genius looks like a 'bum'." He continued: "The 'stock purchase plan insurance' may go out of existence quickly for almost the same reason. A great deal has gone off the books because the concerns themselves have gone out of business. The average mortality of a corporation in Massachusetts is about seven years; therefore when bad times come, the organizations drop off even faster. In a depression they lapse their business insurance because they prefer to do that rather than let their credit become poor. Sometimes in a proprietorship a

business insurance trust helps the credit, but in a corporation it does not affect the credit very much."

Another underwriter, who mentioned as a cause of lapsation the frequent necessity "for laying hands on reserve funds through the cash values of business insurance policies", added: "In my own experience I know of cases where business insurance trusts have lapsed under the pressure of banks (not necessarily those banks named as trustee under the agreement) who were creditors of the business. These banks demanded the lapse of the business insurance trusts on the ground that this insurance was an expense borne by the organization. The banks do not do this from a legal angle, but they are in a position to snap the whip. In one case the business was hard hit and the bank which was a creditor for a substantial amount of money insisted that the business insurance be dropped. Within two months after that, the president of the company (a close corporation owned wholly by two brothers), who was the chief one insured, died suddenly of cerebral hemorrhage induced by the burden of affairs - and the business insurance which should have saved the business had vanished. The bank was morally responsible for what happened, and it still has its stranglehold on the business."

2. Who constructs the plan for the business insurance trust?

Of the ten men questioned, two felt that all parties

concerned - business associates, trust officer, underwriter, and lawyer - should together work out the plan for each business insurance trust. Four believed that the business associates should plan with the underwriter the details of the agreement; one said that the underwriter did much of the pioneer work but that the trustee should also approve the arrangement; and three considered that the business associates and trust officer should alone construct the plan for the trust agreement.

It is well worth while to take up most of these varying opinions in fuller detail because they illustrate clearly the divergent viewpoints of the two groups who are trying to pull in double harness.

The trust officer of one of the largest Boston banks who stated that "all four parties work together on the agreement" explained to me: "The education of the life underwriter in the proper set-up of a business insurance trust rests squarely upon the shoulders of the trust officers. The life underwriter acts as a 'correlator' between trust officer, lawyer, and client. It is his job to find the problem and then bring to that problem the best-trained minds to work out the proper solution. His relationship should be one with an ethical standing. It is particularly a professional relationship. The trust officer brings to the problem technical knowledge of the trust instrument itself and of the legal relationship

between the stockholders or partners. The lawyer brings to the problem the ability through experience to express in legal terms the technical set-up that the trust officer has worked out."

The other man who believed in the desirability of all four parties' working together on the trust plan was an underwriter, and he gave a radically different interpretation of the situation. "The life insurance man should sell and advise with regard to the life insurance and should recommend the trust, calling in the trust officer when the proper time has arrived. The trust officer should serve no other function but to render advice as to the function that the trustee will serve. The disinterested lawyer should draw up the trust agreement, which upon the approval of all the parties concerned (advisers and clients) should then be deposited with the trustee, thus completing the setting up of the trust.

"Personally," he continued, "I have always felt that if the plan is presented properly to the business man, the insurance should be put into force first and that then the man's own lawyer, preferably, or some disinterested lawyer should be called in to draw up the trust agreement. I know that the banks urge the life underwriter to bring the client to them at the start. I prefer to keep it on a professional basis and call the bank in only when the situation has reached a stage where the bank can serve a proper function.

Some of that is self-respect because I do not want aid in selling my own business. Also, in one case where a particularly aggressive trust officer suggested that he would have a good lawyer of his own selection draw up the trust agreement, the result was very unsatisfactory. The trust agreement was very poor, and I had to supervise its complete revision before presenting it to the clients - and I never permitted that procedure to take place again."

Similarly, one of the most prominent life insurance men in Boston never goes to the trust officer until the business insurance trust agreement has been drawn by the lawyer. Then the trust company visés the document before it is signed.

Another underwriter stated: "In the very best banks they say that you have to frame your own trusts. The corporate fiduciaries of Boston have agreed not to draw trusts or wills because that is the business of a lawyer. Few lawyers can draw business insurance trusts, and if they did, they would charge $1,000 for it. The insurance man should usually have his agreement drawn up before going to the trust man. The best banks will bear you out in that. I think the average life underwriter with any leanings toward business life insurance and with access to various bulletins and forms can do a reasonably good job. The associates should review that agreement to see whether there are any errors of omission before going to the trust officer, rather than leave the checking to the trust officials."

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Still another underwriter said: "Before the crash the ----- Bank would send me to depositors to discuss the subject. I prepared the whole digest and left the lawyer to put it into legal phraseology. We prepare the plan that we prefer to have the bank take. However, the average underwriter is at the mercy of the trust company and the lawyers; for although the trust officer may talk coöperation, he is averse to having the intervention of the life insurance man. He prefers to dominate the situation and therefore to isolate the conversation."

A trust officer told me: "I do not know of any case in my experience where the trust officer has initiated the trust and planned the agreement. Sometimes, after the first contact of the three groups, the associates and the trust officer plan the details together, leaving out the life underwriter."

Two other trust officers, however, insisted that to obtain the best results, the business associates and the trust officer ought to draw up the trust instrument, have a trained lawyer put it into legal phraseology, and finally call in the life underwriter only after the agreement is complete.

The trust official who admitted that the underwriters did "a great deal of pioneer work" in business insurance trusts added: "A great many cases have come in here with the idea of business insurance which the life underwriter has

worked out, and after we have looked into it, we have recommended against a business insurance trust. It makes a very pretty picture in words, but when you get right down to the bone of the thing, often they would take care of their business much better by doing something else - often by taking insurance on their own lives."

3. Who is to determine the value of the business?

Of the ten men interviewed, six firmly believed that the owners of the business should determine its value for the trust agreement; one (an underwriter) felt that the owners should decide whether they preferred to value the business themselves with periodic supplemental revisions or to have it valued arbitrarily by the trustee or arbitrarily by public accountants; one (a trust officer) considered that a public accountant could make the fairest valuation of the business; one (a trust officer) thought that appraisal of the business at the death of an associate by three appraisers was the most common method. One (an underwriter) said that he could value the business as well as anybody if the owners would give him the facts he wanted, although he admitted that the problem was highly complicated because of the difference between book value and the real value, which the owners might not wish to use.

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A trust officer of one of the largest banks in Boston gave the following excellent exposition of the majority

opinion: "We (trust officials) adhere to the statement that it is none of our business. Every company has an accountant or hires one from outside. We tell the owners to work it out with him. We would be glad to go over the figures after that, but the determining of the value is the business of the owners and the accountant."

4. What technical method of valuation do you recommend?

Two men out of ten did not recommend any method of valuation; one preferred a "maximum and minimum clause" in the trust agreement; one definitely favored the book value method; two preferred the appraisal method at the time of death; and four recommended periodic revision of the sum mentioned in the agreement.

Of the two who would not recommend any valuation method, one (a trust officer) did not feel that it mattered, while the other (one of the most successful life underwriters in Boston), although he would not recommend a method, considered book value the most common.

The underwriter who liked a "maximum and minimum clause" said: "The most likely procedure is that the owners will give a fairly generous appraisal of their own business interests and will insert in the trust agreement a clause providing that the minimum amount to be paid for each decedent's interest shall be the business insurance proceeds on his life, while the maximum shall be the book value or market

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value of his interest at the time of his death." He added: "I do not know of a single case where they have made an actual appraisal of the value of the stock and adjusted the insurance up or down to meet the case."

The insurance man who favored book value stated: "It depends entirely on the set-up of the corporation, as to how much Goodwill there is in it. That is the only variable factor. They might have a very large Goodwill. If that factor does not enter into it, then they may use book value equal to the asset value not including Goodwill. Book value is what I usually put into the agreement, and I provide that any excess over the last analysis shall be at the appraised value since then. About 95% of my cases are book value on January 1 of the year in which the death occurs."

An equally successful underwriter, however, said: "I have learned not to favor any one method but to give the owners three methods and let them take their choice, because whichever one you favor, they do not." His three methods were book value, appraisal value by three appraisers at the time of a member's death, and fixed value in the trust agreement supplemented by periodic revision by the owners. He personally felt that it was wise to "keep away from the book value method, because inventory values are altogether too evasive." He considered the plan of periodic revision good in the case of small companies, but felt that the appraisal

method was more likely to be satisfactory for large concerns, because the appraisers could determine more accurately the possibilities inherent in the various types of inventories.

One trust officer gave the following analysis of these three methods of valuation: "It all depends on what the trust instrument provides. Sometimes book value is used. This does not usually reflect true values. Therefore it would not be safe to predicate the purchase or sale of the decedent's interest on the book values stated in the agreement. The most common method is to take the appraisal value at the time of one member's death. Under this method three appraisers - one appointed by the surviving associates, one by the deceased's estate, and the third by the other two - make an appraisal of the business at the time of the deceased associate's death. I think that that is the safest method because a great many things can happen before that time. The old method was to file periodical statements of value with the trustee. It might be suitable in certain cases where the stockholders insist upon a valuation fairly representative of the assets of the business. Five or six years ago I drew quite a number of trusts that way. Today on account of the uncertainty of values that method would be less likely to be effective than the method of appraisal at death. The actual case of one large concern shows how general business conditions can affect the valuation of a business. Ten years ago

this organization had three factories, and brought an income to its majority owner of $150,000 a year. Two years ago all three factories were shut down and all employees dismissed except one secretary. The whole fabric of the organization is now completely demoralized, and the company owes the banks a large amount of money. It now pays nothing to its owners."

An underwriter, however, was led by present conditions to a directly opposite conclusion: "The extraordinary change in values brought about by this situation we are going through undoubtedly has had some effect on ideas of valuation. Two years ago there were several different methods of complicated valuation, some of which made you feel that you needed an astronomer or an Einstein to calculate them. Today the Goodwill method is very questionable. If the 'average of the profits over a period of years' method is taken, in many cases that would show the value of the stock as worth less than nothing. Probably the most practical method is based on book value as of a current inventory supplemented by an agreement among the owners of the business as to the value of the shares for the given period until revised by a new agreed statement which should be deposited periodically with the trustee. In many cases the changes are so small that they might be made less often than once a year."

A trust officer who follows the same revision method praised it because "it gives everybody a pretty thorough break".

A still stricter interpretation of the revision method was given by a trust officer in one of the largest corporate fiduciaries in Boston: "Under our system, we stipulate that the owners determine the value and leave with the trustee a letter signed by all parties at interest as to the value of the business. They are to send us another letter whenever they change the value of the business. The last letter contains the controlling price to us as trustee in the event of the death of one man."

The most interesting fact in the whole preceding discussion is the total lack of agreement among these prominent men, accustomed to meeting and exchanging opinions, as to what constitutes not the best but the commonest valuation method. I have recorded here that one man has claimed that distinction for the maximum-minimum device, one for book value, and another for appraisal value. Others told me that the periodic revision method was the one most frequently used. When trained authorities disagree to such an extent about primary facts which they could readily verify, the inexperienced onlooker can only stand appalled and helplessly report their vagaries.

5. Does the trustee often have the complete power of valuation?

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mously answered "no". One of the most prominent underwriters even condemned the question as "silly". Another stated: "The trustee in the business life insurance trust is merely an agent negotiating the transfer of the stock to the corporation in return for the life insurance. The trustee should not have full power of valuation because the corporation should have that power. The trustee is acting for both parties - for both the deceased and the corporation."

A trust officer said: "No, unless (as rarely happens) the trustee has title to the business property."

This unusual unanimity of the ten answers is particularly interesting because one highly esteemed textbook on the subject, written for trust officers and life underwriters, strongly and repeatedly advises that the trustee should have the complete power of valuation of the business at the death of one associate.

6. Do the trustees themselves want this responsibility?

This question, like the last, was answered by a unanimous "no". One underwriter explained: "All they get is the fee of ½% to 1% for the transfer - and they want as little work as possible."

Another underwriter remarked: "My experience is that the trustee has not sought any power which may cause him embarrassment. He does like to have such powers as will make him free from interference on the part of heirs and execu-

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It is interesting to add the supplementary comment of a trust officer: "The trustees are not equipped for it. They would have to go to somebody outside of the bank to appraise the business, and the fee would be charged to the estate."

7. Is the underwriter trained in business analysis?

This question, which was intended primarily for the five underwriters, was politely "sidestepped" by the five trust men. One underwriter regarded any attempt at business analysis from a company's published reports as worthless. A second underwriter felt that insurance men were competent merely to help in analyzing businesses, but not to make a complete analysis themselves. The third replied: "There are not six men in the city of Boston qualified to do it. Their past experience has not brought them in contact with it. The average underwriter does not know the meaning of Surplus except very hazily."

The fourth underwriter answered that in business analysis most underwriters were "woefully weak". "They do not spend five minutes doing that. I have gone over accounting books and statements until I was blind - but the average insurance man might be interested in the financial statement so far as it concerned approaching the case as a prospect, but not otherwise unless as a result of previous training he

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knows how to do that. That is one of the biggest curses of our business. Our men will not pay the price for professional standing. On the other hand, he continued, "the associates in general are always going to have the situation in their own hands. They will put it on an order-giving basis. If they want $100,000 in business insurance, the agent usually will not argue to try to make it $105,000. If the associates want his advice, he must still be diplomatic."

The fifth underwriter gave an even fuller exposition of the facts: "Very, very few are qualified to perform that service. Probably not more than a very small percentage of the underwriters in the community can render that service. The great bulk of underwriters lack the necessary training and education for it. It requires knowledge of business and accounting and law and trusts as well as insurance. The C.L.U. development is calculated to give the necessary training for that service and other than the actual possession of that designation there is no way of determining whether a man has the necessary qualifications. Some knowledge of accounting is absolutely necessary in the analysis of any business statement, because a man can then see through the artificialities. However, what of it? If the owners of the business are satisfied to set a certain valuation on their stock, of what importance is it whether the underwriter or the trust officer differs with them? I personally should not quarrel

with them, no matter what the valuation was, because intangible factors might change the valuation very much from the inventory figures. They might even be using some sentimental factors, but it is their money and their stock and their right to place any value upon it so long as they agree."

As these five men are at the top of their profession and include three writers of nationally recognized material on business insurance trusts, it is safe to accept their verdict and to conclude that the business insurance trust is approached by the average underwriter almost wholly from an insurance rather than an "insurance + business" angle.

8. Does the trustee usually accept a valuation agreed upon by the underwriter and the associates?

Eight answered "yes" to this question, but six of them qualified the affirmative in various ways. A trust officer suggested that the trustee might help the business men to arrive at the valuation if they lacked the knowledge of the process. An underwriter remarked: "The right kind of trustee will ask what kind of method they use. Then he says, 'If it satisfies you, it satisfies us'."

One trust officer said that the trustee would accept the valuation unless it clearly was far too low, while another would call the business associates' attention to any obvious error. In this respect an underwriter commented: "It would be very tactless to tell the owners of the business that they

did not know what the business was worth. Therefore the trust officers would be likely to wait until the trust went into effect."

It is interesting to note that whereas one insurance man said that the trustee might make a suggestion about valuation if he were very intimate with the business associates, another insurance agent replied that if the bank had had dealings with the business and particularly if officers of the corporation were directors of the bank, the trustee might accept without question the valuation set by the business associates. Otherwise this underwriter felt that the trustee might not necessarily accept the valuation.

The tenth man, a trust officer, stated: "No, we would not accept it without question, but we would make certain that it was a value or a method of valuation that would be perfectly satisfactory to them. We do not care what the value is in dollars and cents if it is perfectly satisfactory to all concerned."

9. Has the trustee had accounting training in valuing businesses?

Although this question was designed chiefly for the fiduciaries, two of the insurance men commented that in their experience no trustees had had accounting training in valuing businesses. One of them added that the trust officers were more likely to have had legal experience. Of the five bank-

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8. Has the trustee had accounting training in valuing business?

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ing men only one answered that "the trustee has had this training". One said that he had had none with regard to business insurance trusts. Three others stated that the trust officer would have no need of such training because he could turn over any complicated business statement to either the statistical or the credit department of the bank for competent analysis.

One of these three men explained: "The trust officer has a pretty good grounding in the general idea of business insurance and as to whether or not it is practical in a given case. A good underwriter would have the same knowledge. It is just a matter of commonsense. It would be only after you got into an involved situation that you would have to call in your bloodhounds."

The second said: "All there is to the matter is to get the agreement between the owners. No one else is interested in it. It is no worry of ours."

The third man, however, made the following comment: "Two brothers owned all the common stock and 50% of the preferred stock in a close corporation, while their father owned the other 50% of the preferred stock. The older brother said that the business was worth $400,000, but the younger claimed that it was worth $1,000,000. They had to know the value before making the trust. I said to the younger brother, 'Suppose you die and your widow expects $1,000,000? The only

thing to do is to bring in your C.P.A. and let him value the business based upon all the elements you have just been discussing and see what the business is really worth.' The business was found to be worth $1,500,000. In my experience no dependable source of values can be ascertained except through a thorough audit of these factors by a C.P.A. The factors reported by the C.P.A. should be carefully weighed by the trust department of the bank and confirmed as to their reliability. The trustee should analyze the statement and pick it to pieces."

As these five trust officials represent banks in high standing which have handled the majority of the business insurance trusts hitherto written in Boston, it may be inferred that the average trustee's approach to the business insurance trust has been chiefly from the agency or custodianship angle rather than with an "agency or custodianship + trained business knowledge" viewpoint.

10. Should the members of a firm apply for their insurance before the trust agreement provisions are worked out?

Two bank men said "no", the third trust officer said that it made no difference, the fourth said that it was the better way but not necessary, and the fifth said "yes". Of the underwriters four decidedly favored this method, while the fifth said: "Sometimes, for special reasons, such as an immediate journey or an age change pending, but generally not."

In view of such a wide divergence of opinions, I will quote freely from the actual statements which set forth the underlying reasons.

One trust officer emphatically remarked: "No, because what they need is the agreement, whether they can get cash or not. Insurance is a secondary thing. It provides cash if you have not got it. The insurance is a thing that happens along the line to pay for the business. For example, if they cannot afford insurance, they pay perhaps $10,000 cash and ten notes of $4,000 each. The main thing is the 'business purchase agreement', which is the proper name for the so-called 'business insurance trust agreement', because the principal thing is the agreement. The best method that we know of to work it out is to have insurance, but you do not have to."

Another trust officer stated: "In my experience that point has never come up. I should say that we would not recommend making an application until they knew how they were going to use the insurance after they had applied for it. If a man came in here with a business insurance trust idea and wanted to have it analyzed, we would not tell him to make his insurance application first and then tell him whether he should have the business insurance trust or not. I do not think that we would make any recommendation as to the man's applying for insurance. We would think that that was up to

him. There might be exceptions to that where he needed it very badly."

On the other hand an underwriter answered: "Absolutely. I am not going to sweat over drawing trust agreements until I know whether the parties can pass the examination."

Another underwriter added: "It means an entire rearrangement of the plan if a man is physically unable to meet insurance requirements."

A trust officer made the further suggestion that in case of rejection "they must set up a sinking fund or use a deposit annuity of some kind."

It is interesting to note that one underwriter's analytical reply is the exact opposite of the emphatic statement of the first trust officer quoted on this problem. This underwriter answered: "By all means. The purpose of the whole thing is to safeguard the business, and the essential thing is the insurance - not the trusteeship. The trusteeship is merely an instrument to make it better. The relationship between the insurance and the trust agreement is like the relationship between an umbrella and its handle. The handle of the umbrella is the trust agreement, but the umbrella itself is the insurance - and we must never lose sight of the fact that the umbrella is the vital thing and not the handle.

"I would point out to the client", he continued, "the dangers involved in not having a business insurance set-up.

There is no mention of a trust at that stage of the negotiations. When negotiations have reached the stage where the client recognizes the dangers, then in the elaboration of the machinery, I point out the various alternatives for handling the situation, among which is the business insurance trust, and I recommend it because of the advantages of using an outside, disinterested fiduciary to act as conduit for the transfer of the insurance and the shares of stock (assuming that it is a close corporation). I always believe it important to place the insurance before getting the ramifications of the trust agreement, because the drawing up of the trust agreement may take months because of the proverbial slowness of lawyers to carry out their functions. Therefore, because business insurance is a vital need of the business, I feel it imperative as a service to the clients, aside from the selling factors involved, to put the insurance into force. Then I recommend that they use their own lawyer if they have one who understands trusts, or that they use a lawyer who does understand trusts if theirs does not, and I recommend also that a discussion be had with the trust officer of the particular bank in which they indicate their wish to set up a trust. I never call the trust officer into the picture until this stage is reached in my own practice."

11. If so, who is then the beneficiary of the insurance?

Two underwriters agreed in saying that the insurance

should be payable either to the business itself (particularly if a corporation) or to the one who paid the premiums. One of these two men added that in the latter case the associates should have a subsidiary personal agreement for carrying out the transfer of each associate's interest if he died before the trust agreement was signed. A third underwriter agreed with one trust officer that the insurance should be payable to the wife of the insured. The other six men varied so widely in their statements that I am forced to list each man's opinion individually.

Although the fourth underwriter, who suggested that sometimes the insured's estate might be used as a temporary beneficiary, added that that was "dangerous", the remaining equally prominent underwriter asserted: "It is made payable to the estate and then absolutely assigned over to the trustee when the trust agreement is complete, because then you get away from the danger of having the estate of the deceased sue the survivors for anything that might come up. For instance, suppose that three associates decided to insure each other, paying premiums of $10,000 a year. If the trust agreement was drawn wrong and the creditors put in claims, the widow might sue and say that too much money had gone into the business. Usually the appellant in such a case is refused, but it ties up the settlement of affairs for a year or two. I do not advise making the policy payable to the

corporation. I want to show that it was originally in the estate and that the insured of his own free will took it out of his own estate in putting it under the trust."

One trust officer favored either the corporation or the insured's estate as beneficiary, while another suggested "the estate of the insured, unless there happens to be a large amount of insurance and unless the insured already has a reasonably large estate. In that case the insurance should be payable to his wife, from the standpoint of taxation."

Still another trust officer favored making the insurance payable to the one who paid the premiums.

The remaining trust officer introduced the final variant: "If the premiums are paid by the corporation, the insurance is payable to the corporation. If they are paid by an individual, the insurance is payable to the wife or estate of the one who pays the premiums. It is just a matter of holding the insurance in some name until the trust instrument is drawn up and signed, and then transferring it to the trustee."

It is interesting to note that the second of the two underwriters who agreed on payment to the business or to the one paying the premiums considered both methods merely as "better temporary gap-fillers than having no insurance at all," and that he did not believe it advisable to assign the policy to the trustee upon completion of the trust agreement, but preferred to use the form for change of beneficiary -

thus disagreeing with one of the other underwriters quoted above.

Because this problem, dealing with the actual procedure used, is highly important for the efficient handling of estate and tax matters if one associate should die before the trust agreement is signed, it is extremely and almost incredibly bewildering to the outsider to find nearly as many different plans strongly advocated as there were men to urge them. Surely if trust officers and life underwriters would consult both within their own groups and between the groups, they could determine more intelligently which of these recommended plans would be the most efficient for each type of case likely to arise.

12. What type of policy is preferable for business insurance trusts? Does the choice vary with the case?

Two trust officers had no preference, and the third favored any type of policy except term insurance, because all other types have a cash value. The fourth trust officer agreed with one underwriter in preferring "ordinary life" (or "straight life") as first choice, limited payment life as second choice (under certain circumstances), term insurance as third choice (for new, small businesses or for firms formed for only a short period), and endowment insurance only where a sinking fund is necessary (such as to retire a bond issue or to permit one associate to withdraw his interest at

a given age). The fifth trust officer usually preferred ordinary life, but used limited payment life under certain conditions, and also used endowment insurance where a sinking fund was necessary. Two underwriters agreed in naming ordinary life as first choice except for new concerns, when they would temporarily use term insurance. The fourth underwriter would use ordinary life under all circumstances, whereas the fifth underwriter preferred endowment insurance, gave ordinary life as second choice, and used term insurance only in small concerns with little money. The following analyses of reasons for the various preferences, grouped under each type of policy, show the customary divergence of opinion.

A definition of each type of policy referred to in this question will be found in Part I, Section VIII, Problem 8 of this thesis.

With regard to "ordinary life" or "straight life" policies, one underwriter uses only this type, three other underwriters and two trust officers list it as their first choice, and one underwriter puts it as second choice. This type of policy, therefore, comes the nearest to receiving a unanimous verdict from the men interviewed.

One underwriter gave an excellent explanation of this general viewpoint: "If it is an established business, ordinary life should be used. Ordinary life is the fundamental

basis for life insurance. It is a permanent plan of insurance and provides cash values. It requires the smallest premium of any permanent form of insurance. Anything added to premium payments is taken out of working capital, and the company can earn more from that working capital by keeping it in the business."

Another underwriter added: "It depends very largely, however, upon the circumstances involved and the ages of the insured and also upon their resources."

Term insurance was named as second choice by two underwriters and as third choice by two underwriters and a trust officer, for use in certain special circumstances. It was thus second in popularity to the ordinary life policy.

One underwriter stated that he would use "either ordinary life or term insurance, depending upon the financial condition of the concern. In a brand new concern, where the organization expense is large, I believe in adopting a plan calling for term insurance, to be converted into ordinary life when, as, and if the business shows a profit."

Another underwriter replied: "Two obvious cases where term insurance would be recommended are: where there is inability to pay the larger premiums required for a permanent form, with the expectation that after a short term of years the change can be made to the permanent form; and where it is definitely understood that the business is to have a lim-

ited life, for example, a partnership for the length of time necessary to carry out some particular form of contract such as a real estate development project."

One trust officer remarked that "term insurance should be bought where the risk is less and the cost needs to be less."

It is very interesting to note that, in sharp contrast to all the foregoing views, one underwriter answered: "Some like to use term insurance, but that is only postponing the evil day," and one trust officer came out flatly with the reply: "They should not use term insurance."

With regard to the limited payment policy, two underwriters emphatically stated that they would never recommend it, and two underwriters never used it, whereas two trust officers and one underwriter named this type as second choice in certain cases.

One of these two trust officers commented: "Limited payment life is good in the case of older people." This comment is particularly interesting because of its contrast with the theoretical opinion quoted in Part I, Section VIII, Problem 8, b.

The second trust officer remarked: "Where the parties are engaged in a successful business and want to create a sinking fund of cash values as soon as possible (without having to pay the higher premiums for endowment insurance), they

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should use limited payment life policies."

The underwriter who named limited payment life policies as his second choice gave an excellent analysis of the value of "higher collateral forms", which require higher premiums but have higher cash values than the ordinary life type. He said: "In some cases I recommend higher collateral forms because, as has been thoroughly demonstrated, it is so important to build up a cash reserve outside of the business, and the time may well come when the ability to obtain funds in an emergency may be the test as to the solvency and stability of the business. It will be pointed out in objection that in the event of death, more money had been paid for the insurance than need have been; but I do not place much weight on that objection, because most business insurance is discontinued before any associate dies (the average life of a business is quite short before dissolution and liquidation), and because even in the more permanent organizations there will be many times when emergency funds will be needed."

Endowment insurance was emphatically given first place by one underwriter, was used only for the establishment of sinking funds by another underwriter and by two trust officers, was never used by two other underwriters, and was condemned by the fifth underwriter almost as vigorously as the first had advocated it. The latter stated: "Endowment insurance has no place in business, barring exceptional circum-

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stances where the associates may want to stow away a lot of money. It is very unusual."

The insurance man who chiefly favored the endowment policy declared: "What I prefer is one thing and what the clients prefer is another matter. I like an endowment policy because the expectation of personal service to the business among business executives is rarely over twenty-five years. Therefore I like to have the company have the money to buy out each executive's interest when his period of value to the business is over. Also this type of policy puts the company in a much better position because of its high cash value. I like the endowment policy best, but I cannot always sell it. In such cases I sell the ordinary life policy."

One of the two trust officers who favored endowment insurance remarked that in general this type of policy was used to establish a sinking fund in order to retire a funded debt or an issue of stock. The other trust officer stated: "Where, because conditions are peculiar, the organization feels that it can afford a higher rate of premium payments, and where a fund must be provided at the end of a given number of years, some endowment plan is very useful."

The underwriter who favored endowment insurance only for sinking funds declared: "In almost no cases would I recommend the endowment policy for business purposes. It might be arranged, however, to provide for the liquidation of a bond

issue, with the specification that in the event of the death of the head of the firm prior to the maturity date, the bonds would be paid prior to the maturity date, including a premium because of the anticipation of the payment."

13. Should old policies, or some old and some new, or only new policies be used in business insurance trusts?

Two trust officers had no preference, one trust officer and one underwriter said it depended on the individual case, one underwriter wished only old policies, one trust officer would take old policies if necessary for completing the insurance program of protection, the fifth trust officer did not wish old policies, and three underwriters favored new policies.

The trust official who claimed that it depended on the case cited one example where old policies were advantageously used: "The sole owner of a lumber company worth $100,000 wished to establish a business insurance trust, so that his three chief assistants could readily purchase his business upon his death. Because he was fifty-nine years old, however, the premiums on his life would prove burdensome for these men. He already had had for some years insurance of $50,000 on his own life. Therefore he turned that into the business insurance trust so that the three men could pay at a lower premium rate on that insurance. He also agreed to pay half the premiums on the additional $50,000 insurance

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required. The business insurance trust agreement provided that upon his death, his estate should receive from the three new owners of the business additional compensation in payment of the premiums which the deceased owner had advanced on half of the $50,000 of new insurance."

The underwriter who wished to use only old policies declared: "I favor the entire use of old policies if the clients have them. If they already have business insurance payable to the corporation, they can make it payable to the trustee. If their old policies are their personal insurance, it is up to them to do what they want to with that insurance. If they have more personal insurance than they want, they can sell it to the corporation, which will make it payable to the trustee under the business insurance trust."

The trust officer who did not wish to use old policies replied: "We do not favor the use of old policies because adjustments and cash values must be considered. You cannot put old policies into a trust without covering everything in the trust agreement. We would rather take out new insurance that starts clear."

One underwriter declared: "There is danger in using old policies. You must take account of the cash values of the policies when taken over, and you must recompense the original owners for these cash values. There is also the problem as to whether you are liable for tax on these policies, par-

ticularly with regard to the dissolution. For example, if a personal insurance policy was taken over by the company from the original owner, and five years later that company merged with another company, so that that policy was either taken over by the new company or transferred back to the original owner, there might be a question of estate or inheritance taxes. As another example, suppose that a personal policy is taken out payable to the insured, who later sells it to the corporation for its then cash value. If the internal revenue men learn of that transaction, they may tell the corporation: 'You made a profit on that insurance policy because you purchased it for its cash value instead of having to pay the total premiums since it was taken out, and therefore you must account on your tax return for the premiums that you would otherwise have paid over that term of years.' Moreover, the average man wishes to keep his personal insurance policies."

Still another insurance man brought out clearly a different and highly important view of the situation: "Aside from the selfish aspect of the underwriter, it would seem advisable to use new insurance, because old insurance, unless taken out for business purposes, is intended to take care of entirely separate needs of a personal nature - and it would be an injustice to a man's dependents to divert insurance from the replacement of his personal life values to the replacement of his stock interests in his business. Of course

if there is old business insurance, the only objection to which is that it is payable in a faulty manner, so that it is not enjoying the advantages obtained if handled through an outside fiduciary, then only enough new insurance should be added to that old business insurance to complete the total amount which the organization needs."

It is interesting to see that although this question was asked of trustees trained in looking after estates and in the knowledge of family problems, and of insurance men used to selling insurance to protect the home, nine out of ten talked elaborately about complications of adjustment, taxation, and the personal wishes of the insured about selling the policy - and only one man stressed the loss of protection to the family caused by involving the personal insurance (meant to protect the home) with the business interests. Yet this latter view is extremely important for the family's sake, and is highly endorsed by authorities on business insurance trusts. It is set forth from the theoretical viewpoint in Part I, Section VIII, Problem 9 of this thesis.

14. Are business insurance premiums usually paid annually or oftener?

Two trust officers did not know the answer to this question, three underwriters said "usually annually", and one trust officer qualified this reply by adding "not oftener than semiannually".

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The fourth trust officer gave a fuller explanation: "If a corporation is paying the premiums, it usually pays annually. If individuals are paying the premiums, they usually pay quarterly or semiannually. Probably the great majority of premiums are paid annually, but in these times many people have probably had to change their premiums to a monthly basis."

One underwriter gave the following suggestion: "My personal experience has been that the parties prefer to handle premiums as they do heat, light, and power on their budgets, because the annual basis represents rather a sudden deduction. If a seasonal business, it would probably have annual premium payments. For instance, a florist would pay his premiums in the spring. If there is little to choose between seasons in the business, the chances of selling the business insurance are better on a monthly budget plan."

The fifth underwriter gave the following statement: "It varies. I have probably every type of payment from monthly to annually among my clients. The determining factor is business convenience. If it can be paid annually there is an interest saving. Sometimes, especially in these times, the interest charge on monthly payments is merely a replacement of interest charges which would be made on bank loans of corresponding amounts - and the combination of the client's convenience in payment and his use of the money is frequently sufficient reason for paying premiums oftener than once a

year. In this way clients are not dependent on the bank, but are taking care of their premium payments in easier installments, from current income. For example, one firm has conveniently budgeted payments of $200 a month, whereas $2400 a year, all paid at once, would be burdensome."

The fifth trust officer favored a plan whereby "you can remit monthly to the insurance company the annual premium divided by 12, and the company allows you interest and makes an adjustment at the end of the year. The last payment may be smaller because of the interest which the company has allowed you on the amounts deposited during the year."

15. If several policies are used, do you advise having "staggered" payments?

Three trust officers were not interested in this problem, three underwriters and one trust officer strongly favored staggered payments, the fifth trust officer considered staggered payments advisable, the fourth underwriter favored them in some cases, and the fifth underwriter disapproved of them.

One of the underwriters who favored them illustrated an ingenious system of staggered quarterly payments: "In one case the insurance was divided into three policies with quarterly payments of $1700 on the first policy, $1700 on the second, and $1600 on the third. These payments were staggered a month apart, so that they virtually had the advantage

of paying monthly premiums, while actually paying at the quarterly premium rate."

16. Should the policies provide for an emergency "automatic loan" from the insurance company for premium purposes?

Two trust officers were not interested, while the third answered: "The policies cannot provide for an automatic loan if the insurance company will not agree to it. Several insurance companies do not make this provision. Those companies which do not have the automatic loan provision, however, have policy contracts providing against the lapse of the policy."

One life underwriter, who said that his company did not make the automatic loan provision, added: "I prefer to arrange the loan as a special transaction if there is no alternative."

Another insurance man who held the same views explained: "I am going to say no, because I know my fellow man so well. The average individual has the feeling that his premiums are all paid forever if there is an automatic premium loan. I would rather work a little harder to remind these men than have them draw the life-blood out of the policy."

In direct opposition to the preceding views, however, one trust officer thought the automatic loan provision a good idea, another trust officer answered "always", and three leading insurance men said "yes, absolutely", one of them

adding: "You cannot tell when some of these fellows may forget a premium. I have always put it into every policy that I have written."

Again the onlooker stands appalled in the presence of these many-minded authorities.

17. Should stock be deposited in escrow with the trustee endorsed in blank, or be assigned absolutely to the trustee?

This question, suggested by one of the men interviewed, was asked of three underwriters and four trust officers. One underwriter emphatically favored absolute assignment of stock to the trustee; one trust officer thought that it made no difference which method was used; the three remaining trust officers and one underwriter strongly urged blank endorsement of the stock and its deposit with the trustee in escrow; and the remaining underwriter answered: "I have no preference, but I find an increasing number of people who will not deposit the stock under any terms under present conditions. They wish to retain the right to borrow on their stock if necessary but not the right to sell it, and they make the business insurance trust subject to the reservation of this right."

The sole underwriter who favored absolute assignment of stock declared: "As far as taxation goes, unless you absolutely assign the stock over to the trustee you have done nothing. If you do not have it absolutely assigned over, you

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still have it in your possession. The deposit of stock in blank is effectual, but it leaves it open so that creditors can attach it."

The general consensus of opinion of the four men who favored endorsement of the stock in blank and its deposit in escrow was that this method caused less trouble for the trustee, while still placing the stock in the trustee's hands so that it would be easier for the trustee to carry out the terms of the agreement when it came time for the trust to operate. One trust officer added: "There should be a clause in the trust agreement that no stock may be withdrawn from the trustee without the written consent of all parties to the agreement."

The theoretic aspects of the deposit of stock with the trustee have already been fully discussed in Part I, Section VIII, Problem 28 of this thesis.

18. What is your procedure when one member of a firm is uninsurable?

I find that the only way to deal with the varied answers which I received is by quotation or summary of the individual opinions, rather than by any general summary.

One trust officer thought that the procedure depended on the relative generosity of the associates. An underwriter advised in most cases the setting up of a sinking fund for the uninsurable member, with the deposits arbitrarily made

equal to the normal premium rate on a 10-year or 15-year endowment policy on his life.

Another trust officer made the partly similar suggestion: "We recommend that the associates set up a reserve or sinking fund for that particular person and that they arrange to deposit periodically in that fund an amount equal to or greater than the premium which they would have carried on his life if he had been insurable. These deposits should be as large as possible."

The third trust officer, who also recommended a sinking fund, commented: "It all depends on the man's age, his relative ownership in the business, whether he has any heir to leave the business to, and whether he has a key employee in the business."

An underwriter, after advocating a sinking fund, continued: "Another way is to make the uninsurable man assume a larger proportion of the premiums on the insurable members, and to reimburse his estate at his death for the extra premiums, in addition to the payment to his estate for his interest in the business."

The fourth trust officer, on the other hand, said: "In a partnership of two men, we recommend that the insurable man carry his own insurance instead of having a business insurance trust. There are, however, many different possibilities, such as depositing a sinking fund with the bank."

The fifth trust officer suggested either a sinking fund within the company or the use of a deposit annuity, which he defined as follows: "Under the deposit annuity plan instead of setting aside each year the amount of $1700, for example, so that at the end of a ten-year period a $20,000 fund will have accumulated to provide for the uninsurable associate, that yearly deposit of $1700 is placed with some life insurance company. Then if the uninsurable man dies before the maturity of the fund, the company will take care of the difference. This plan relieves the business of the care of investing the money, places it in the hands of experts, and always guarantees its safety."

An underwriter presented a slightly divergent plan: "Under the retirement annuity the uninsurable man makes an annual premium deposit with the insurance company. In the event of his death, the total premiums are returned, and if his death occurs after the seventh year, more than the premiums will be returned. Under that plan there is no insurance taken out, but the cash values are much greater. I think that this new plan will take the place of all previous attempts to solve this problem.

"I have heard," he added, "of a plan whereby the uninsurable party made periodical deposits in a special fund invested by the trustee. These deposits are based on the American Experience Mortality Table - an advantage, because

only between 50% and 60% of the people actually die as early as the table says that they should die."

The remaining underwriter suggested a sinking fund, with deposits equal to the intended premium payments on the uninsurable associate, set aside in a savings bank and entirely apart from the business. He preferred, however, a second plan, different from any recommended by the other men: "The second method is to buy with those corresponding premiums additional insurance policies on the lives of the men who are insurable. I think that this method is much the better, because if the uninsurable man dies first, the others have the cash value of the additional policies, whereas if one of the insured men dies first, the others have the face value of his additional policy to set aside in the savings bank until the uninsurable man dies."

It is interesting to note that both plans suggested by this last underwriter are identical with those recommended in Part II, Case 7 of this thesis. Some of the methods favored by the other men are mentioned in Part I, Section VIII, Problem 10.

19. In your experience has a business insurance trust clearly given any firm greater confidence?

Of the ten men interviewed, two trust officers and two underwriters emphatically answered "yes". The others had not had any such cases called to their attention.

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One of the two assenting underwriters made the interesting comment: "Generally speaking, my clients having business insurance trusts feel a better sense of security, satisfaction, and peace of mind. They do not seem to have any uneasy feelings as to how things will be adjusted after death. The only thing that has bothered them in view of the bad times is that their partners do not die quickly enough."

20. Do business insurance trusts repay the fiduciary for his effort?

Two of the underwriters considered this a question for trust officials, and the three other underwriters said that because of their probable short duration these trusts did not pay the fiduciary directly but merely as bait for other trust business. One trust officer stated that business insurance trusts did not pay, another felt that the fiduciary took these trusts in a spirit of altruism and to create good will, two others said that they paid as bait, but the fifth trust officer claimed that they paid if the trusts were large enough.

To quote some of these opinions in further detail, one underwriter said: "I think that one of the reasons why trust departments take these trusts is that the insurance is likely to go into personal insurance trusts."

Another added the flat statement: "The business insurance trust is the bait. The banks will not admit it, but

that is it."

Yet one bank official did admit it, saying: "They pay because very seldom is a business insurance trust made where there is no personal trust added to it. The trust itself is not the thing. It is what the trust is connected with that counts, as far as the bank goes."

Another trust officer went further into the matter, explaining: "If an underwriter brings two prospects to this bank, I find out whether they have wills, and if they have, I get a look at those; I ask whether they have life insurance trusts; I offer the services of the investment trust; and I offer the agency service. It is the value of the contact service that pays. I will not consider business insurance trusts with any client if he is only willing to talk business insurance trusts with me."

that is it."

SUMMARY AND CONCLUSION

The answers of the majority of the corporate fiduciaries and life underwriters may be summed up as follows:

The business depression has caused many recent lapses in business insurance trusts. Trust agreements should be planned by the underwriter and the business associates, although a large minority feel that the business associates and the trust officer should plan them. The owners of the business are the proper ones to determine its value for the trust agreement. A periodic revision of the sum mentioned in the agreement is the most advisable method of valuation. The trustee usually does not have and never wants the complete power of valuation of the business. The underwriter is not trained in business analysis and need not be. The trustee usually accepts the valuation agreed upon by the underwriter and the associates. The trustee has not had accounting training in valuing businesses and does not need it. It is wiser for the members of a firm to apply for their insurance before the trust agreement provisions are worked out, but the authorities completely disagree as to who in that case should be the temporary beneficiary of the insurance. The favorite type of policy is ordinary life. There is a slight leaning toward the use of new rather than old policies. There is great divergence of opinion as to whether premiums are paid

annually or oftener, but the majority favor staggered payments if several policies are used. Provision in the policies for an emergency automatic loan from the insurance company for premium purposes appeals to a slight majority. Stock should be endorsed in blank and deposited in escrow with the trustee. When one member of a firm is uninsurable, the favorite device is a sinking fund, which may be administered in any one of several ways. A few authorities have found from experience that business insurance trusts have given firms greater confidence. There is a strong feeling that except as bait business insurance trusts do not repay the fiduciary for his effort.

It is very interesting to see that all the authorities were agreed on only the following points: that the trustee neither had nor wanted the complete power of valuation, and that underwriters had no training in business analysis.

On a few points, such as the depression lapse, the owners' valuation of the business, the willingness of the trustee to accept this valuation, the trustee's lack of accounting training, the advantage of applying for insurance before drawing up the trust agreement, the use of ordinary life policies and staggered payments, the deposit of stock endorsed in blank, and the fact that business insurance trusts do not repay the fiduciary for his effort, a large majority concurred on one method. On all other points there

was wide variation of opinion.

Both underwriters and trust officials in general should realize that if they wish to build good will for their institutions and successful reputations for themselves as possessing the ability to deal competently with business insurance trusts, it is absolutely essential for them to gain more knowledge as to the best methods available and the best procedure under the various circumstances most likely to arise. It is difficult to believe that there is real reason for quite such wide divergence of opinion as this thesis continually shows. One cannot help wondering how far some of these answers may be merely a justification of "the method I know best" or "the method I like to use", rather than a deliberate adoption of the best method suited to the case.

In view of the many books and articles written about business insurance trusts, it is startling to find how new and untested a venture they really are. I was amazed to learn from the leading promoters of these trusts in Boston, some of whom are nationally recognized as authorities in this field, that as yet few of them have had a single trust put to the test of a death claim. In effect, therefore, these business insurance trust promoters are in the position of a young graduate of a purely theoretical medical course, who writes and fills emergency prescriptions which are planned to preserve the patient's health and even his life in the future,

without having had the opportunity to try out even one prescription on a single patient under stress. This situation has induced in some underwriters and trust officials a passive, unanalytical acceptance of theoretic methods devised by others, in some a vigorous, sincere, and highly intelligent search for light on the various problems arising, and in some an almost rampant, empirical individualism in method.

It must also be realized that the main value of a business insurance trust to an organization centers in its power to continue or conserve adequately the true value of the business. The insurance men and trust officials who ignore the force of this truth seem to this onlooker to be skating over very thin ice. From my own point of view, gained from a very thorough training in accounting and from four years' intensive study of trust methods in general and of both life insurance trusts and business insurance trusts in particular, I do not hesitate to predict that until the amount of each business insurance trust written is systematically and scientifically correlated to the true worth and needs of the individual business, these trusts will remain, as they still are, merely an interesting experiment.

Most insurance men and trust officers, with their own complete lack of accounting training, find it impossible to believe one fact which all trained accountants know - that a great many small and medium-sized single proprietorship busi-

nesses, partnerships, and corporations have a really appalling lack of knowledge about the actual condition and worth of their own business. The picture of the small, inadequately-trained shopkeeper which H. G. Wells drew in the "History of Mr. Polly" is exactly as true to life here in the United States today as it was in pre-war England. It is equally true of many fair-sized organizations which drift along without adequate cost accounting or definite knowledge of their own true financial status at any time until some crash comes. How are such owners competent to place an adequate valuation on their own businesses? How can they determine the amount of business insurance protection which they need, when they either lack the knowledge of the proper methods of valuing their business, or consider that those approved methods are too burdensome and take too much time, or feel that they can come sufficiently near to the correct valuation of the various items by estimates which are essentially mere guesswork? Surely insurance men and trust officers should possess the ability to check such statements, at least to the extent of determining whether they are correct, or whether a complete audit of all books of the concern by a C.P.A. is the only method of arriving at the true valuation.

The average insurance man's attitude toward an accounting basis for business insurance is evidently a survival of the pre-C.L.U. era - of the days when men frequently "took up

insurance-selling" for lack of power to do anything else, when they hunted down prospects and sold them as much insurance as possible, in whatever type of policy either the agent or the prospect happened to prefer, and with absolutely no thought of suiting either the policy or the amount of insurance to the prospect's individual case.

Similarly today many underwriters are accepting business insurance trusts on an "order-giving basis". In other words, they unquestioningly permit the customers to buy package drugs to the amount they wish to order, trusting to luck that the dose will prove correct and that that particular class of drug will cure the patient, instead of being some unsatisfactory and even harmful patent medicine. Yet when the average underwriter sells life insurance, he does not sell it on an order-giving basis. On the contrary, he feels that he is a trained professional who is far more competent to prescribe adequately as to the quantity and quality needed for each individual case than the client is. From the facts which the client supplies he visualizes the situation and estimates the need. Then, like a skilled doctor who has completed his diagnosis, he prescribes for the particular case. Here there is no barrier of lack of technical knowledge to block his power to help and his power to sell.

Some of the underwriters whom I have interviewed have told me that the only variable factor in business is Goodwill.

I suspect that they may live to learn that there are many other variables - that even audited statements of reserves, sinking funds, depreciation, treasury stock, accounts receivable, inventory values, and the valuation of fixed assets may easily each and all contain either deliberate or unintentional pitfalls for the unwary, which can mislead one or all of the parties concerned, including the business associates themselves.

Underwriters who wish to sell business insurance should realize that accounting knowledge on their part, with ability to recognize and skill to avoid the pitfalls of ignorance or of intention in the valuation of businesses, would greatly increase their clients' confidence in their advice.

To turn now to the trust officials, the general fiduciary attitude toward an intelligent accounting basis for business insurance trusts is clearly an extention of the self-centered banking attitude of "we take 'em young and train 'em up ourselves". This attitude, incidentally, leaves many a man helpless if the bank which has always employed him fails or ceases to need his services. As a system it rarely gives the average subordinate a broad and intelligent understanding of the banking field, or even of any accounting and auditing which has not chanced to fall in his direct, individual path of duty - which is usually limited, in all but the smallest banks, to a strictly monotonous and deadly dull routine.

The trust officials claim and genuinely believe that they would refer any complicated accounting problem to experts. Yet it has long been a well-known fact that sometimes skill and training are necessary in order to detect the presence of some serious complication. In other words, to return to the sickroom comparison, the untrained patient himself often is completely ignorant as to what symptoms show a condition requiring expert care - and even a trained nurse does not always recognize a genuine need for a specialist.

Even if the trust officer feels that he plays a distinctly minor part in the actual drawing up of the business insurance trust agreement, and that he may safely leave such matters as the valuation of the business and the amount of insurance needed to the sole judgment of the business associates and the underwriter respectively, he must still remember, for his own sake, that one thing is certain: if the heirs of any deceased associate are dissatisfied with the settlement which the business insurance trust agreement provides, they are exceedingly likely to blame the underwriter considerably, the deceased still more, the surviving associates even more, and the trustee (whom they have previously believed to be experienced in handling such matters) most of all - and the trustee's reputation is by far the most vulnerable for any attack. There is real risk, therefore, that if a fiduciary has merely played the part of an uninterested

spectator while the business insurance trust agreement was being drawn up, believing its role merely that of future disbursing agent, it may unexpectedly find itself charged with unfairness, and may thus build up ill will instead of good will among the heirs. The trust officer must always keep in mind that in business insurance trusts as in all other types of trust, the fiduciary, after all, is the party to the proceedings who later steps out into the foreground and becomes the one with whom the heirs must deal - and that therefore those heirs are likely to attach more importance to his present as well as to his future acts than to those of the other parties.

The world moves, business methods change, and with the coming of the business insurance trust has also come the time for both trust officials and insurance men to shake off the handicapping limitations of tradition and of inadequate training in accounting and in the power of business analysis.

The general feeling among business insurance trust promoters is very strongly that although the present depression has temporarily slowed down the impulse to create business insurance trusts and has even caused a few lapsations, nevertheless it is teaching those who have such trusts their true value, and is creating the desire for them in many who now cannot afford them. Several of the promoters believe that as soon as better times return and prosperity seems "just around

the corner", a wave of new business insurance trust creation will surge upward even past the last prosperity high-water-mark. Trust officials and insurance men may well use this waiting-time to prepare themselves in accounting and business analysis so that they will be more adequately trained to meet every need in diagnosing the case of each individual organization when the rush for business insurance trusts begins.

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